



HM Revenue  
& Customs

# Annual Report and Accounts 2014-15

Report by the Comptroller and Auditor General



National Audit Office

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HM Revenue & Customs 2014-15 Accounts

# Report by the Comptroller and Auditor General

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Audit Departments Act 1921

Sir Amyas Morse KCB  
Comptroller and Auditor General  
National Audit Office

16 July 2015

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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 must consider the adequacy of the systems to assess, collect and allocate tax revenues.

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# Coverage of this report

HMRC corporate document	Coverage of this report
Trust Statement	<p>HM Revenue &amp; Customs (HMRC) will collect £517.7 billion tax revenues for 2014-15. We cover this in <b>Part One</b>.</p> <p>Under the Exchequer and Audit Departments Act 1921 the Comptroller and Auditor General (C&amp;AG) must certify whether the Trust Statement is true and fair, and whether HMRC has used the income and expenditure for the purposes Parliament intended.</p> <p>The C&amp;AG has concluded that:</p> <ul style="list-style-type: none"> <li>the figures in the Trust Statement are true and fair; and</li> <li>HMRC has used income and expenditure for purposes Parliament intended.</li> </ul> <p>The 1921 Act also requires the C&amp;AG to consider whether HMRC's revenue systems to collect taxes are adequate. We found that HMRC's revenue systems are adequate subject to the observations in this report and our other reports to Parliament (<b>Parts Two to Four</b>).</p>
Resource Accounts	<p>The annual cost of running HMRC was £3.1 billion in 2014-15. HMRC paid £42.8 billion in benefits, including £29.1 billion of personal tax credits payments.</p> <p>Under the Government Resources and Accounts Act 2000 the C&amp;AG must certify whether HMRC's Resource Accounts are true and fair, and whether HMRC has used the income and expenditure for the purposes Parliament intended.</p> <p>The C&amp;AG:</p> <ul style="list-style-type: none"> <li>found the Resource Accounts are true and fair; however,</li> <li>has found material levels of error and fraud in tax credits expenditure (<b>Part Five</b>).</li> </ul>
Annual Report	<p>HMRC reported £26.6 billion compliance yield in 2014-15.</p> <p>HMRC asked us to review its compliance yield data in 2014-15, after our audit last year uncovered a significant error in the baseline HMRC used for agreeing targets with HM Treasury.</p> <p>Our conclusions about compliance yield are in <b>Part Three</b>.</p>

We review whether HMRC is getting value-for-money. We report our findings to Parliament under section 6 and section 9 of the National Audit Act 1983. We refer to recent value-for-money work throughout this report.

# Summary

## 2014-15 accounts

### This report

**1** This report is our commentary on HM Revenue & Customs' (HMRC's) performance in 2014-15. We report findings from all our statutory audits of HMRC this year including its financial statements, the adequacy of its revenue collection systems and the value for money it achieved from its spending. Each audit comes under different legislation (see Coverage of this report, opposite).

**2** Our audit of HMRC covers most of the tax revenues the government raises, and the benefits HMRC pays out. HMRC raised £517.7 billion of tax revenues this year (some 80% of total revenues raised by government) and paid out £42.8 billion in benefits – approximately one-fifth of the total the government paid. The annual cost of running HMRC, which is the second largest government department in terms of staff numbers, was £3.1 billion in 2014-15.

**3** Each year we choose parts of HMRC's business to report on in more detail. Last year's report considered: how it allocates resources to different types of compliance work, and measures and reports the success of such work; progress in collecting taxes under the Swiss Tax Agreement; and work to reduce tax debt owed.

**4** This year's report is in five parts:

- Part One is an analysis of **tax revenues and spending in 2014-15** and commentary on the trends, based mainly on figures in HMRC's financial statements.
- Part Two describes **how HMRC estimates the tax gap** and identifies and assesses the scale of the **risks to tax collection**.
- Part Three considers the robustness of **HMRC's estimate of compliance yield**, one of its key performance measures. HMRC asked us to review the measure after our work last year identified a significant error.
- Part Four looks forwards at HMRC's **strategy to improve tax administration**.
- Part Five gives an update on **progress in managing fraud, error and debt from personal tax credits**, and explains the basis of Comptroller and Auditor General's (C&AG's) qualification of the Resource Accounts.

## Summary findings

**5** HMRC aims to get the highest compliance with tax law possible while being efficient and maintaining public confidence in the tax system. HMRC must choose where to focus its resources. It must balance the need for efficient systems that help willing taxpayers, with activities to encourage and, where necessary, enforce compliance with tax law.

**6** HMRC's strategy over the past five years has been to reduce costs, while increasing its compliance work to secure additional revenues. Its settlement with HM Treasury at the 2010 Spending Review included a £917 million reinvestment of its efficiency savings in compliance work to generate additional revenues of £7 billion per year by 2014-15.

### Tax revenues and spending in 2014-15

**7** The Trust Statement reports that HMRC will collect £517.7 billion of tax revenues for 2014-15, an increase of £11.9 billion (2.4%) on 2013-14, building on a 6.3% increase in 2013-14. HMRC records revenues in the Trust Statement on an accruals basis – actual cash receipts were £514.4 billion (£492.6 billion in 2013-14).

**8** HMRC has reduced tax losses (mainly taxes written off where there is no practical way to collect them) to £4.2 billion, below £5 billion for the first time in a number of years. HMRC also reduced the balance of tax debt (taxes that are overdue and outstanding at 31 March 2015) to £13.0 billion (£13.3 billion at 31 March 2014), paragraphs 1.10 to 1.11 and 1.14 to 1.17.

**9** HMRC needed to increase by one-third the amount it set aside for its legal claims provision (where taxpayers are disputing HMRC's assessments through litigation) to £7.2 billion, and to increase by 22% the amount it disclosed as contingent liabilities (possible liabilities from cases currently in litigation), from £29.2 billion at 31 March 2014 to £35.6 billion at 31 March 2015, paragraphs 1.12 to 1.13.

### Spending

**10** While HMRC has collected more tax revenue this year, and paid out more in benefits and credits, it has reduced its administration expenditure from £3.3 billion to £3.1 billion (6% decrease). It has continued to improve its ratio of '*Revenue collected per £1 of Administrative expenditure*' from £153.64 in 2013-14 to £166.95 in 2014-15, paragraph 1.18.

### HMRC's assessment of the tax gap and tax risk

**11** HMRC faces risks to collecting tax efficiently – ranging from honest mistakes to large-scale criminal attacks. HMRC estimates how much tax it does not collect (the 'tax gap'), while identifying ongoing risks to revenue and their relative scale ('tax at risk'), and measuring how effective its response is.

**12 Between 2005-06 and 2012-13, HMRC estimates that the tax gap fell as a proportion of the tax due from 8.5% to 6.8%.** HMRC estimated the tax gap was £34 billion in 2012-13, a slight increase from its 2011-12 estimate of £33 billion (6.6% of the tax due). Income taxes (41%) and VAT (36%) are the taxes which account for most of the tax gap, while the largest share by customer group comes from small and medium-sized enterprises (44%), paragraph 2.5.

**13 We consider HMRC's estimate of the tax gap to be a useful indicator of the scale and nature of non-compliance with the tax rules, and of HMRC's long-term performance.** Estimating the tax gap is not an exact science, however: there is a significant time-lag, and the nature of the tax gap makes it inherently difficult to measure. The International Monetary Fund has concluded that HMRC produces one of the most comprehensive studies of the tax gap available internationally, but made some recommendations for how HMRC's methodology could be strengthened, paragraphs 2.6 to 2.11.

**14 HMRC is seeking to strengthen the links between the tax gap and its understanding of tax risk and of the effectiveness of its compliance interventions.** HMRC has identified 54 strategic risks to revenue with a potential impact of £48 billion, and estimates that its compliance action to mitigate these risks saved at least £14 billion in 2013-14. But compliance yields in relation to these risks are highly variable. More systematic and deep analysis is needed to understand whether levels of yield are related to the inherent nature of the risks or the effect of HMRC interventions. As HMRC deploys new techniques, such as increasing its mass messaging to nudge taxpayers in the right direction, it needs to develop a suitable range of measures to understand their effectiveness, paragraphs 2.17 to 2.25.

**15** In the next few years, we will report how well HMRC uses its analysis of tax risks to decide how to use its resources. We will assess how well HMRC identifies and tackles different forms of tax evasion and criminal attack.

## Estimating compliance yield

**16** Compliance yield measures the effectiveness of HMRC's enforcement and compliance activities. It is one of its main performance indicators, and is used to agree targets with HM Treasury for spending on compliance work. The 2010 Spending Review set HMRC's funding and delivery commitments until 2014-15. As part of this, HMRC committed to make efficiency savings while doing more compliance work to secure additional revenues. HMRC estimates compliance yield to give management information about how its compliance business is performing. Almost half of its staff now does compliance work.



**17** HMRC has continued to develop how it measures its yield from compliance activities over the 2010 Spending Review period to reflect the impact of its wide range of existing and new compliance work. It has progressively adapted the measure to reflect changes in its compliance activities and has improved the evidence base to support its estimates of the impact of these activities. As it has evolved the measure, HMRC has taken a prudent approach, collecting relevant evidence before making changes and reducing its estimates appropriately where there is uncertainty.

**18 HMRC's estimate of compliance yield performance increased to £26.6 billion in 2014-15, up 11 per cent from 2013-14.** As we reported in 2013-14, it is a complex hybrid of measures which are designed to reflect the breadth of HMRC's compliance activities. Because each component of compliance yield covers a different type of activity, they are calculated in different ways and cover different time periods. The breadth of the measure expanded in 2014-15 and it has historically varied from year to year. Caution is therefore needed when making year on year comparisons. In 2014-15, the measure changed to reflect that (paragraphs 3.10 to 3.11, 3.18 to 3.19 and 3.22):

- HMRC added a new type of yield to its measure in 2014-15, an estimate of revenues it expects to receive under accelerated payments legislation, totalling £768 million (including some £200 million estimated to arise as a result of changes in taxpayer behaviour). It also included a significant amount of yield (£576 million) from a long-running compliance project it had chosen to exclude from the previous year's total. The effect of these changes is to increase compliance yield by £1.3 billion in 2014-15: this equates to 48% of the reported increase in yield between 2013-14 and 2014-15. HMRC's reported compliance yield in the absence of these changes would have been £25.2 billion (2013-14: £23.9 billion).
- Accelerated payments legislation brings in payments up front from tax avoidance cases before the case is settled. HMRC reports the cash amounts it has received and repaid under this scheme as yield during the year. In adopting this simple approach, HMRC makes no adjustment in year for the possibility that cash received in individual cases may have to be repaid in future years, or for the possibility that the final award to HMRC may be higher than the cash already received. Although HMRC is confident that these two issues may offset each other in a particular financial year, as amounts received under the scheme are recognised up front, HMRC's current treatment may lead to its annually reported performance being distorted. HMRC will keep the assumptions supporting its approach to scoring this yield under review.

**19 As a performance measure, the yield provides a reasonable proxy for assessing the impact of individual interventions and to support decisions to be made by HMRC in allocating resources.** The methodology supporting the yield is adequate and our work has provided evidence that HMRC has effective processes in place for collating data and ensuring its quality. HMRC has quality assurance processes. Where these processes uncover errors and weak documentation, HMRC works to address these (paragraphs 3.24 to 3.25).

**20 As a published measure of HMRC's performance, there remains a risk that readers might still reasonably conclude that the compliance yield is the amount of cash generated each year arising from HMRC's enforcement and compliance activities.** HMRC continues to improve the accuracy, clarity and transparency of how it reports compliance yield in its Annual Report and has made improvements in 2014-15 to help the reader interpret its reported performance. However, the measure was not designed to track the amounts HMRC reports as yield to the benefits the Exchequer received in the current year and a significant element of the yield calculation relies on estimates of current and future benefits. Given these factors, it is important that the reader is clearer that the yield is not a cash figure and the inclusion of ranges around the estimated elements of yield would help to achieve this (paragraphs 3.21 to 3.23).

**21** The next Spending Review provides an opportunity for HMRC to rethink its approach to reporting compliance yield. Building on the work we have undertaken this year, together with recommendations we and the Committee of Public Accounts made last year, **we recommend that HMRC:**

- Takes forward last year's recommendation made by the Committee of Public Accounts that it should be more transparent about its compliance yield estimates in its external reporting. HMRC should continue to publish more detail about how it calculates yield, and should be clearer about how much it has actually collected in cash terms and explain how uncertainty affects its estimates.
- Strengthens its evidence base to support the discount factor it applies to its cash collected category of yield.
- Makes its methods for calculating yield consistent across categories. As for the cash collected category, HMRC should consider whether its existing assumptions supporting the scoring of accelerated payments remain relevant; and develop a way to score the tax collected in future years which is consistent between its future revenue benefit and product and process yield categories.
- Aims to maintain a comparable measure of compliance yield over time and, where this is not appropriate, it continues to report clearly the impact of any changes it makes to its method in its key accountability statements to Parliament.

## Strategy to improve tax administration

**22 HMRC launched a high-level strategy to transform the tax system in July 2014.** In the March 2015 Budget, the Chancellor announced the “end of the tax return” for millions of customers. HMRC is working on its plans to roll out digital tax services based on customers’ needs, and how it will measure its performance, paragraph 4.10.

**23 HMRC plans to provide modern, personalised online services for customers, making better use of its data and helping customers to get things right first time.** HMRC is aiming to give every taxpayer and every business an online tax account to access all their tax information in one place. The tax account will include information HMRC holds and will check information automatically as the customer enters it. Customer support will be through several channels, such as web-chats, text messages and email, paragraphs 4.11 to 4.12.

**24 The 2015 spending round will make detailed decisions about funding for tax administration beyond 2015-16, and how HMRC will measure its performance.** HMRC must decide how to measure and capture the benefits expected from its transformation. It recognises its current performance measures will be insufficient to measure the impact of its transformation on customers or additional revenues. Strong performance measures will be an important accountability tool for Parliament and taxpayers as HMRC fundamentally changes how it provides services, paragraph 4.14.

**25 HMRC’s transformation plans are ambitious and have significant delivery risk.** The transformation will be complex, and more radical than HMRC’s previous change programmes. HMRC already has an ambitious timescale to phase out the tax return starting in 2016, and this is just one part of its transformation plans. HMRC will need to balance ambition with realism about its critical assumptions and contingency planning. It also has to manage significant operational change while it changes how it procures and manages its IT (including digital) services. Implementation problems are inevitable and HMRC will need commitment and resilience if it is not to be deflected from the delivery of its strategic vision, paragraph 4.16.

## Progress reducing tax credits fraud and error

**26 The C&AG has qualified his regularity audit opinion on the 2014-15 Resource Accounts because of material levels of fraud and error in the payments of personal tax credits.** HMRC’s central estimate of fraud and error in 2013-14 is £1.26 billion, which represents 4.4% of finalised entitlement. This is the most recent estimate of fraud and error available. HMRC has reduced fraud and error from 8.1% in 2010-11 to the lowest level since tax credits were introduced in 2003-04, paragraphs 5.5 and 5.9.

**27 The personal tax credits balance of overpayments rose in 2014-15, from £6.5 billion at 1 April 2014 to £6.9 billion at 31 March 2015.** In-year recoveries increased from £815 million in 2013-14 to £967 million in 2014-15.<sup>1</sup> In 2014-15, HMRC employed a private sector company to collect tax credits debts so it could re-deploy resource to collect other debts, paragraphs 5.22 to 5.25.

**28 HMRC's recent reduction in fraud and error is encouraging and it is conducting further analysis to fully understand the reasons for all of the reductions.** In June 2015, HMRC revised the 2012-13 estimate for fraud and error overpayments from 7.0% to 5.3%. HMRC's latest estimate for 2013-14 confirms the downward trend has continued. This decline suggests that HMRC's initiatives to tackle specific fraud and error risks have had an impact. For example, it has worked with credit reference agencies to increase the number of checks and used new data to address the undeclared partner risk. It is also using data on claimants' earnings from its real-time information system to provide better information on household income. HMRC has not yet had time to assess the reasons for reductions more fully and is planning to conduct further analysis, paragraph 5.6.

**29 HMRC has extended its approach to addressing fraud and error.** It began a project with a private sector contractor to increase the number of compliance interventions it undertakes. It is also seeking to stop overpayments occurring by introducing new obligations for claimants to provide more information. Its approach has delivered sustained reductions for most main risk types. HMRC must continue to find innovative ways to tackle remaining losses, fully understanding the causes and the extent to which further reductions are achievable for each risk type, paragraphs 5.12 to 5.21.

**30 HMRC will continue to address tax credits fraud and error alongside managing the transition to Universal Credit, where it will need to work closely with the Department for Work and Pensions (DWP). Child Benefit expenditure will take on more prominence in the Resource Accounts as tax credits payments start to decrease. We recommend that HMRC:**

- Undertakes an exercise to further evaluate how the 2012-13 revision has affected each risk type, and conducts more detailed analysis to track how operational activities are delivering reductions by risk type. Such analysis will inform operational decisions on the prioritisation of fraud and error activities.
- Ensures that it maintains proportionate controls and interventions on tax credits during the transition to Universal Credit, paragraphs 5.26 to 5.29.
- Undertakes additional analysis of the underlying causes and entry points of fraud and error on Child Benefit to better target its controls at these risk areas, and establish whether they have sufficient information from claimants to support its assessment of entitlement and eligibility, paragraphs 5.31 to 5.33.

<sup>1</sup> The figures quoted here for recovery do not align directly with the figures disclosed in Note 6.2 of the 2014-15 Resource Accounts. The recovery target captures only cash collected and the value of time to pay arrangements. The Resource Accounts figures also include other adjustments to the receivables balance.

## Summary of findings from our value-for-money work

**31** We published two value-for-money reports on HMRC in 2014-15 – on its Aspire contract and its management of tax reliefs – and reviewed its response to our, and the Committee of Public Accounts', recommendations over the life of the last Parliament.

### **Review of recommendations**

**32** The Committee of Public Accounts made taxation a key area of focus during the last Parliament. In February 2015, we reviewed HMRC's response to our and the Committee's recommendations since 2010 and found that HMRC had accepted and implemented most recommendations. We concluded that HMRC engages strongly with the accountability process and robustly implements those recommendations it has accepted. We also found that HMRC had made good progress against its strategic objectives and in many of the areas of the Committee's focus, but that a lot remained to be done to raise the quality of customer service to an acceptable level.

### **Aspire contract**

**33** HMRC managed its Aspire contract well (for outsourcing most of its technology projects and services since 2004). We praised HMRC's strong track record in introducing new technology and providing continuity of its core systems that are essential to collecting tax revenue. However, we identified that the phasing out of Aspire presented significant risks to HMRC's technology strategy if it cannot build commercial and technical capability before contract end in 2017. In January 2015 the Committee of Public Accounts said that HMRC had made little progress in defining its needs and appeared not to appreciate the scale of the challenge. In March 2015, HMRC told the Committee it had set up direct commercial relationships with each of the major companies, Capgemini, Fujitsu and Accenture, who were previously part of the Aspire consortium. This was helping with some early transition work and controlling ICT costs. However, HMRC had not had formal sign-off of its business case for replacing Aspire.

### **Tax reliefs**

**34** We found that some types of tax relief require proactive management, especially those that have specific policy objectives. Tax reliefs perform many functions, but have common features and similar risks. HMRC accepts that it bears responsibility for evaluating whether tax reliefs are meeting their aims and for assessing their costs and benefits. We found some good practice, but also inconsistency and fragmentation in how HMRC administers reliefs, with poor information-sharing on risks, costs and benefits. We recommended that HMRC should develop a method to identify groups of similar reliefs and identify what level of administration is appropriate for each type. We have seen signs of a more specific and focused approach emerging. An example is the specialist unit set up to administer patent box relief, which is developing new ways to monitor risk and respond quickly to deviations in the relief's use. We have encouraged HMRC to move forward on this, developing techniques to apply to each tax relief in a way that is proportionate to risk.

## Conclusion

**35** HMRC has ambitious plans to modernise tax administration in the coming five years as it embarks on its third major change programme since its creation in 2005. Over the last Parliament, HMRC met its strategic objectives to increase compliance yield and save costs. It made less progress in improving customer service, which still falls well below the standards customers should expect. Overall, HMRC has managed the risks to its core functions well and balanced this carefully with opportunities to harness new technology and data to enhance its business. We consider HMRC as among the strongest government departments for managerial competence and its capability to make changes. However, it must manage significant challenges as it makes its next transformation. We will report on HMRC's progress as the programme unfolds.

**36** HMRC is now making detailed cost and delivery plans for the next five years, and will agree the funding and performance levels it will be accountable for during the next spending round. HMRC must improve its performance measures and how it reports its performance publicly. Measures must be broad enough to reflect the objectives and progress of its transformation programme, and robust and consistent enough to be comparable over time. It should also ensure its public statements on performance are fair, balanced and understandable, clarifying any areas of uncertainty when reporting figures. These considerations should be prominent as HMRC agrees new performance measures as part of the 2015 Spending Review.

**37** In fulfilling our statutory duties under the Exchequer and Audit Act 1921, while recognising that no tax collection system can ensure that everyone meets their tax obligations, we conclude that in 2014-15 HMRC had 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.

# Part One

## Financial performance in 2014-15

**1.1** This Part provides a brief commentary on HM Revenue & Customs' (HMRC's) financial performance in 2014-15.

### Tax revenues

**1.2** The revenue HMRC reports in the Trust Statement for 2014-15 was £517.7 billion (£505.8 billion in 2013-14) (**Figure 1**). HMRC prepares the Trust Statement on an accruals basis. This means that the revenue figure reported relates to tax due on earned income or activities during the financial year, regardless of when the cash is received. In 2014-15, HMRC received some £514.4 billion in cash (£492.6 billion in 2013-14).<sup>2</sup>

**1.3** Revenue increased by 2.4% in 2014-15 (in 2013-14 it increased by 6.3% compared with 2012-13). The taxes that contributed most of this increase were VAT, which increased by £5.7 billion (5.3%), and income tax and national insurance contributions, which increased by £2.3 billion (0.9%). Some smaller taxes that increased significantly were capital gains tax (up 46.2% to £5.7 billion) and climate change levy (up 50% to £1.8 billion). In contrast, petroleum revenue tax fell significantly from £1.1 billion last year to less than £0.1 billion this year.

### Where tax revenues are used

**1.4** Some of the total revenue of £517.7 billion was collected on behalf of other government departments. HMRC collected national insurance contributions of £108.0 billion (2013-14 £106.7 billion) on behalf of the National Insurance Fund and National Health Service, student loan repayments of £1.8 billion (2013-14 £1.5 billion) on behalf of the Department for Business, Innovation & Skills. It transferred £31.5 billion (2013-14 £30.7 billion) of revenue to its Resource Accounts to fund tax credits.

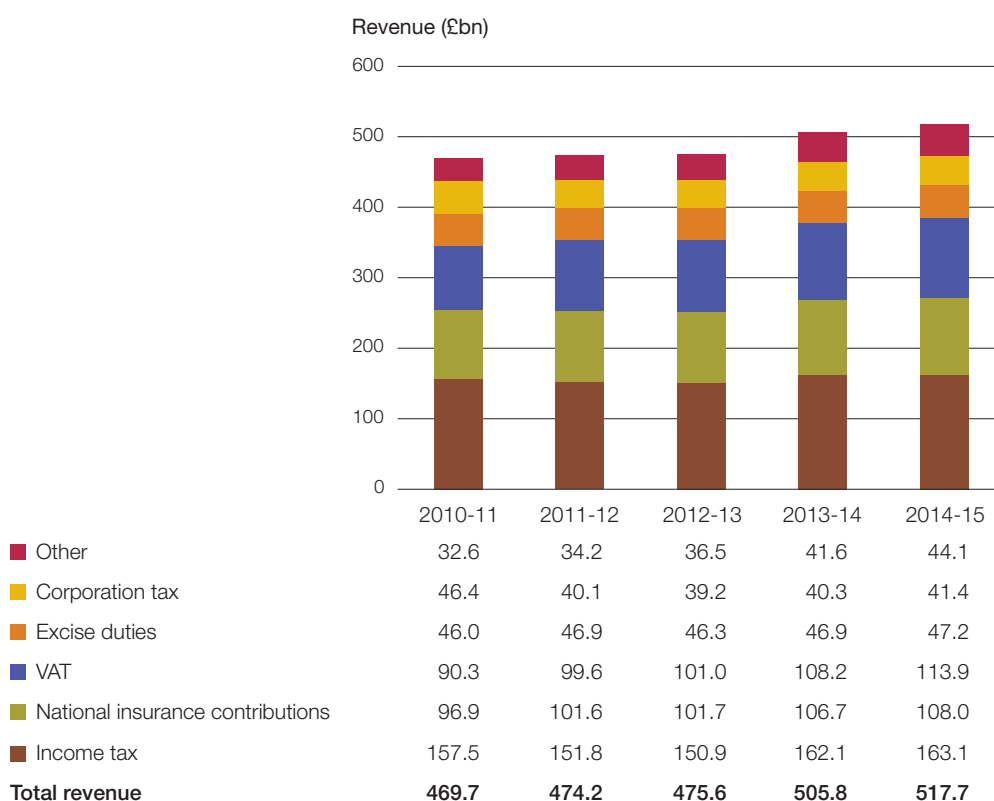
**1.5** After taking these into account, together with HMRC's losses, impairments and provisions, the net revenue of £364.0 billion (2013-14 £360.9 billion) was transferred to the consolidated fund. This is the government's current account, which is used to fund its chosen spending plans for the year. HMRC contributes around 80% of the total receipts recorded in the consolidated fund.

<sup>2</sup> HMRC also publish receipts on a cash basis which can be found at: [www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk](http://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk)

**Figure 1**

## Tax revenues 2010-11 to 2014-15

Total tax revenue has increased in each of the past 5 years



Source: HM Revenue &amp; Customs' Trust Statements 2010-11 to 2014-15

**Tax assessed but not yet collected**

**1.6** Of the total tax revenue of £517.7 billion (2013-14 £505.8 billion), HMRC had not yet received £115.7 billion – 22% of revenue (2013-14 £113.6 billion, 23%). This consisted of:

- £26.0 billion (2013-14 £24.3 billion) due from taxpayers but not yet received (receivables); and
- £89.7 billion (2013-14 £89.3 billion) of taxes not yet due from taxpayers, but earned in the financial year (accrued revenue receivable).<sup>3</sup>

<sup>3</sup> Note 4 to the Trust Statement.



## Accelerated payments

**1.7** The Finance Act 2014 introduced legislation that enables HMRC to issue an ‘accelerated payment notice’ requiring payment of tax and/or national insurance that is in dispute as a result of their use of a tax avoidance scheme. There are a number of conditions that must be satisfied before a notice can be issued, including that the arrangement used is notifiable under the ‘disclosure of tax avoidance scheme’ regime or is subject to a ‘general anti abuse rule’ counteraction notice, and there must be an open enquiry or appeal in connection with the tax/national insurance in dispute.

**1.8** These ‘accelerated payments’ were included in the Trust Statement for the first time in 2014-15. HMRC has recognised £1.2 billion of revenue at the point when the ‘notice to pay’ was issued, which is before the enquiry or dispute has been resolved. As at 31 March 2015, HMRC has received £0.6 billion of these payments. The balance is made up of amounts which are due but not yet paid, or amounts which are not yet due because the 90 day payment date has not yet been reached or statutory representations are being considered. Accelerated payments, whether received or receivable, are not disclosed separately in the Trust Statement but are included within the revenue for the related tax.

## Impairments

**1.9** HMRC recognises that there is a risk that some of the tax revenue owed will not be collected or may prove not to be due. Accounting standards require the Trust Statement to reflect this risk. As a result, HMRC has estimated that it may not collect £8.5 billion (2013-14 £6.6 billion). This impairs the overall balance due from taxpayers to £17.5 billion (2013-14 £17.7 billion). This does not mean that HMRC will not collect these amounts, but reflects that there is a chance that it may not. The degree of impairment varies across taxes (**Figure 2**). VAT and income tax carry the highest risks, which include VAT liabilities being uncollectable due to company insolvencies.

## Losses

**1.10** Receivables that have been impaired may still be collected, but in some cases HMRC assesses that the tax is unlikely to be collected and it is either written off, where there is no practical way to pursue it, or it is remitted, where HMRC decides not to pursue it on value-for-money or hardship grounds.

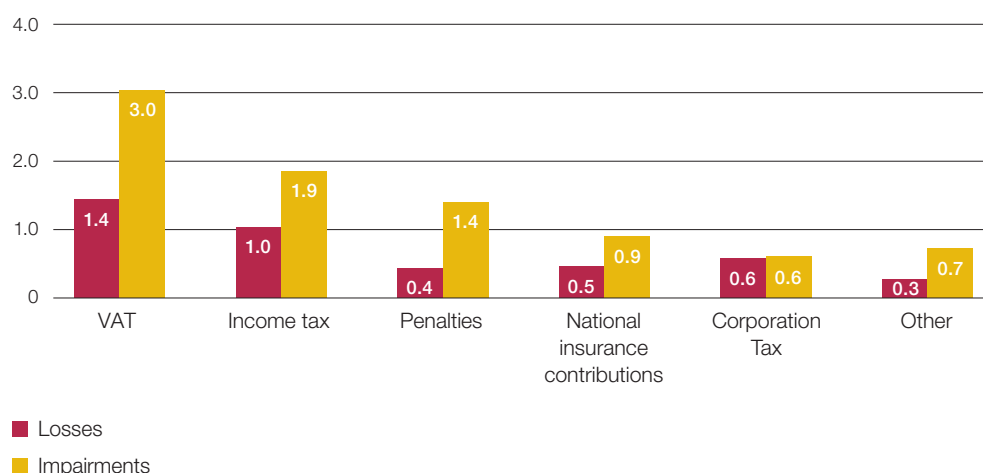
**1.11** Amounts written off totalled £3.9 billion (2013-14 £4.5 billion) and amounts remitted totalled £0.3 billion (2013-14 £0.6 billion). In total, losses fell by £0.9 billion compared with 2013-14. Much of this decrease related to income tax losses, which fell by £0.6 billion, offset by increases in other taxes such as corporation tax, which incurred £0.1 billion more losses than in the previous year (Figure 2). The main reasons for tax revenue losses, including those for high-value cases (more than £10 million), are disclosed in Note 7.2 to the Trust Statement.

**Figure 2**

## Losses and impairments

VAT and income tax carry the highest risk that tax will not be collected

Losses and Impairments (£bn)



Source: National Audit Office analysis of HM Revenue & Customs Trust Statement 2014-15 and underlying data

**Provisions and contingent liabilities**

**1.12** Some revenue collected and reported in the gross tax revenue figure will later be repaid to taxpayers. This may be because taxpayers have overpaid, taxes due are reassessed for previous tax years, or because taxpayers claim reliefs and allowances. HMRC reports two types of provision:

- Legal claims** where taxpayers have disputed the interpretation of legislation through the courts and are seeking a reassessment of the tax payable. The outcome depends on the courts, but HMRC expects it will have to repay £7.2 billion as at 31 March 2015 (2013-14 £5.4 billion).
- Oil field decommissioning costs** where companies offset costs of decommissioning oil and gas fields in the North Sea against tax they have previously paid on those fields. These costs can be carried back to earlier years indefinitely, in contrast to other taxes that are time limited. HMRC has estimated that it will have to repay £7.5 billion as at 31 March 2015 (2013-14 £3.1 billion). As HMRC has set out in Note 8.3.1 to the Trust Statement, it has revised its approach to estimating this provision. The increase since 2013-14 is largely due to HMRC taking a longer term view of its likely repayments of petroleum revenue tax.

**1.13** HMRC also discloses contingent liabilities, which are possible liabilities to HMRC. The liabilities for legal claims have risen by 22% to £35.6 billion at 31 March 2015 (2013-14 £29.2 billion). This is because HMRC has revised its estimates for cases currently in litigation and taken into account court decisions during the year. It is important that HMRC maintains an up-to-date assessment of the progress of key legal cases and any potential accounting and budgetary consequences.

## Debt

**1.14** HMRC's Trust Statement reports a figure of £26.0 billion of 'receivables' (tax owed) at 31 March 2015. This includes £13.0 billion of overdue tax debt, which is when a tax liability is outstanding and collectable after its due payment date. Tax debt excludes tax credits debt, which is discussed in Part Five.

**1.15** The value of tax debt at the year end fell to £13.0 billion<sup>4</sup> at 31 March 2015 compared with £13.3 billion at 31 March 2014. HMRC managed a total of £54.7 billion of new tax debt during 2014-15. This was £1.9 billion less than in the previous year (**Figure 3** on pages R19 and R20). During the year, HMRC collected £40.5 billion (£39.6 billion in 2013-14). The main reason for the decrease in the debt balance has been an increase in the amount of debt collected during the year.

**1.16** HMRC has seen a slight increase in debt older than one year, which accounts for 31% of the year-end debt balance (**Figure 4** on R21). The balance of aged debt has increased to £4.0 billion at 31 March 2015 from £3.7 billion at 31 March 2014. Within this category of debt there has been an increase in Time to Pay arrangements (TTP), which despite remaining on the debt balance represent debts that are being actively repaid in instalments. The terms of these instalments vary from a few months to several years.

**1.17** We reported in last year's Standard Report that HMRC was refreshing its debt strategy to help improve debt collection.<sup>5</sup> The key changes in 2014-15 are:

- **Introduction of the market integrator:** HMRC is currently preparing for the cross-government 'debt market integrator', due to be introduced in 2015. The market integrator should act as a single point of contact to manage debt placed with the private sector for collection on behalf of HMRC and other government bodies.
- **Working collectively with other parts of the business:** HMRC is currently working with other parts of its business to reduce the creation of debt and improve the efficiency of some of the tax collection processes.
- **Self-service options:** HMRC is currently working to introduce digital services. These will give customers self-service options on their 'time to pay' and to code out their debts.

<sup>4</sup> The Real Time Information element of the year-end debt balance has been estimated based on February 2015 figures.

<sup>5</sup> Comptroller and Auditor General, *HM Revenue & Customs Annual Report and Accounts 2013-14*, Session 2014-15, HC 19, National Audit Office, July 2014; R48, paragraph 4.11.

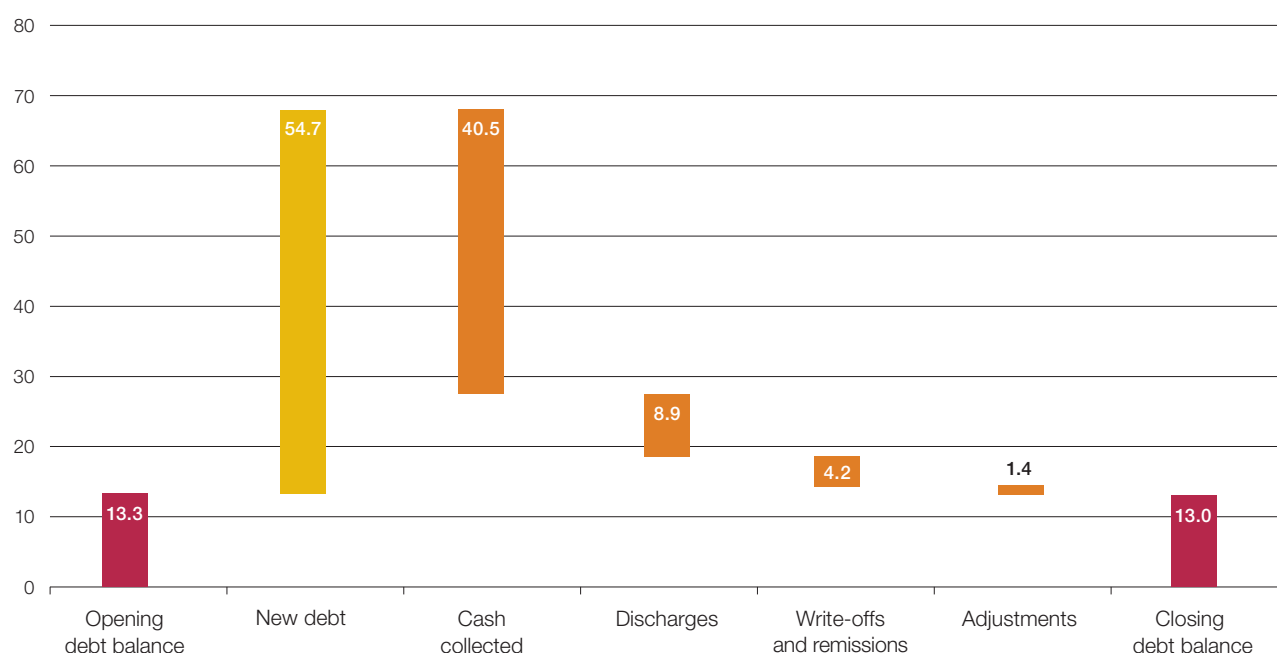
**Figure 3**

## Debt movements

HMRC has collected more debt in 2014-15

2014-15

£ billion



■ Year-end debt balance

■ Movements which increase the debt balance

■ Movements which decrease the debt balance

**Notes**

- 1 Movements exclude tax credits debt.
- 2 Debt is written off in situations where there is no practical way to pursue the liability. Most write-offs occur automatically and are outside a department's control, such as where the debtor is insolvent.
- 3 Debt 'remission' (a concept unique to government) is where a department decides not to pursue a debt. This can be on the grounds of value for money where the cost of pursuing the debt would be greater than the benefit, or because it is not the most efficient use of limited resources, compared with other priorities.
- 4 Discharged debt is where HMRC amends or cancels a debt after receiving further information that determines the taxpayer's final liability as being lower than the figure originally estimated.
- 5 Adjustments are due to manual adjustments to reconcile between debt balance figures in debt management systems and movements, such as cash collected, in other financial systems.

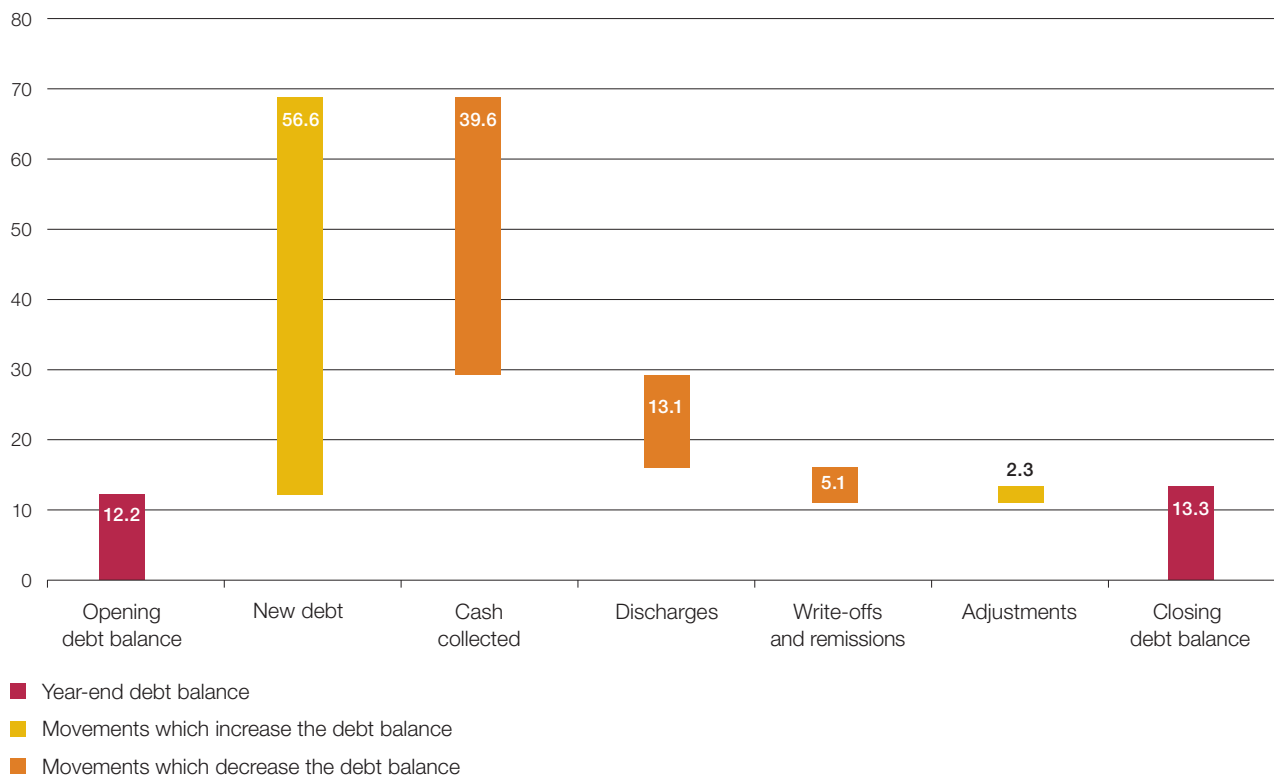
Source: HM Revenue &amp; Customs

**Figure 3** *continued*

## Debt movements

2013-14

£ billion



## Resource Accounts

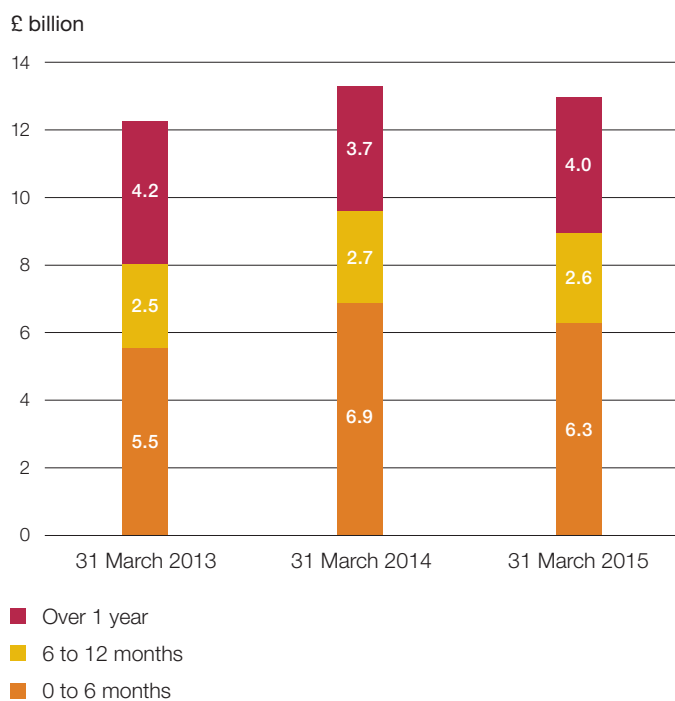
**1.18** HMRC has collected more tax revenue this year, and paid more in benefits and credits. At the same time, it has reduced spending on administration from £3.3 billion to £3.1 billion (6% decrease) (**Figure 5** on page R22).

**1.19** Tax credits have been reported in the Resource Accounts since 2011-12, having previously been included in the Trust Statement. This change arose from the clear line of sight project, which aimed to simplify government financial statements. Tax credits in the Resource Accounts are those that result in a payment to the taxpayer. Other reliefs that are offset against liabilities, and are integral to the tax system, are reported in the Trust Statement. The tax credits reported in the Resource Accounts are personal tax credits of £29.1 billion (2013-14, £29.3 billion) and corporation tax reliefs of £2.1 billion (2013-14, £1.6 billion). Child Benefit payments of £11.6 billion (2013-14, £11.5 billion) are also reported in the Resource Accounts.

**Figure 4**

## Tax debt by age

HMRC has seen a slight increase in debt older than a year

**Note**

1 Trend analysis showing change in composition of age of debt.

Source: HM Revenue &amp; Customs data

**1.20** Since HMRC's creation following the merger of the Inland Revenue and HM Customs and Excise ten years ago, the number of staff permanently employed by the core department has fallen by more than one-third, from 97,000 in April 2005 to 57,000 in March 2015. Staff numbers have fallen from 61,000 full-time equivalent staff at March 2014 to 57,000 at March 2015 (7%) (**Figure 6** on page R23). Personal Tax has seen the largest fall (27%). Staff numbers in enforcement and compliance have fallen slightly this year, after increases in recent years as HMRC focused resources in this area. Against the overall reduction, staff numbers in some directorates have risen. For example, in Business Tax they have increased by 40%.<sup>6</sup>

**1.21** Total staff costs for the core department have fallen by 4% compared with 2013-14.<sup>7</sup> This is a lower reduction than for overall numbers of staff. It reflects the change in staff profile as technological improvements require fewer processing staff, with relatively more resources moved into more senior roles.

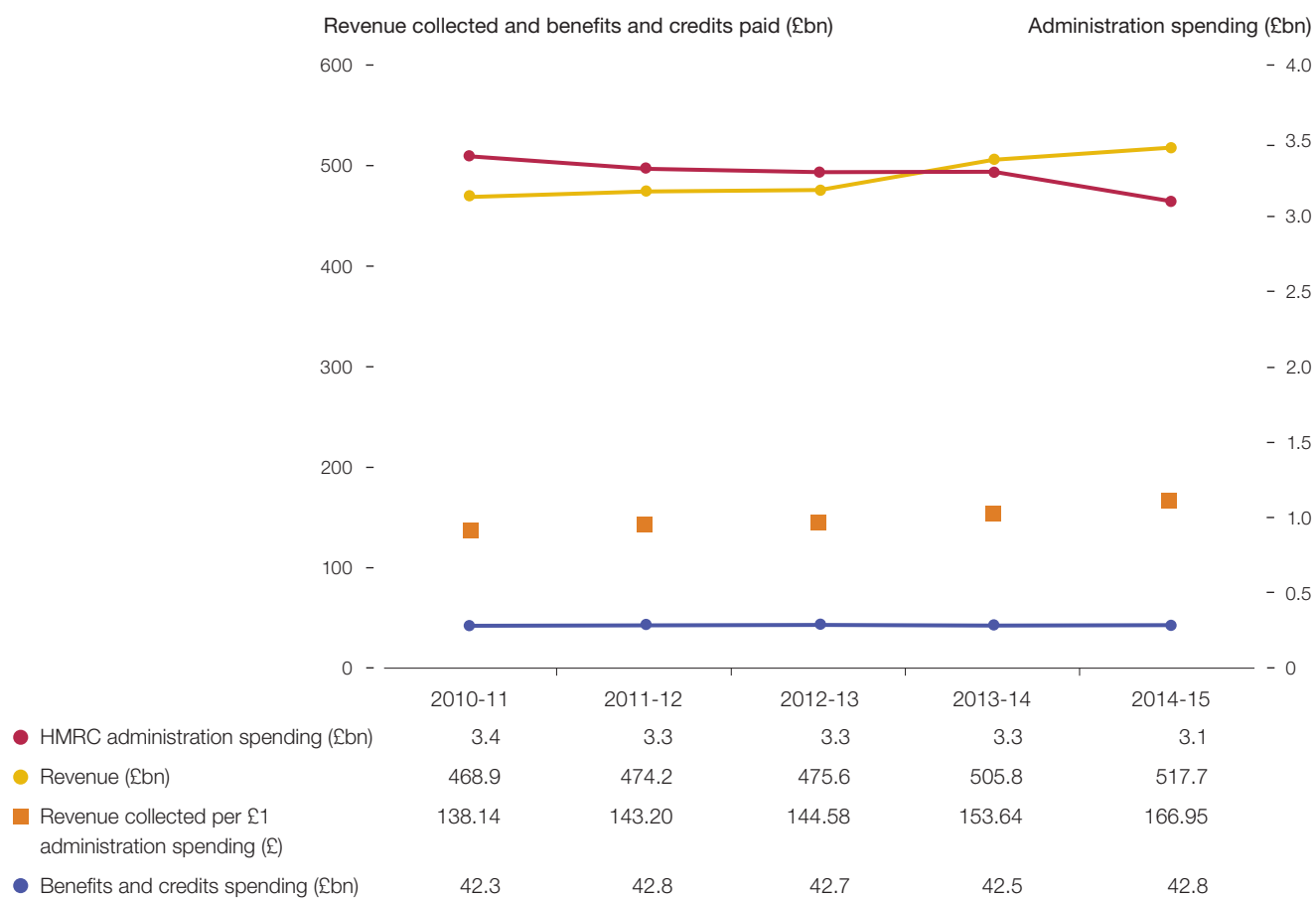
<sup>6</sup> These staff increases were due to internal restructuring from Enforcement and Compliance to Business Tax Directorates.

<sup>7</sup> Total staff costs as stated in Note 3 to *HMRC Resource Accounts 2014-15*

**Figure 5**

## Revenue and spending

HMRC has reduced administration spending while increasing revenue collected and increasing benefits and credits paid

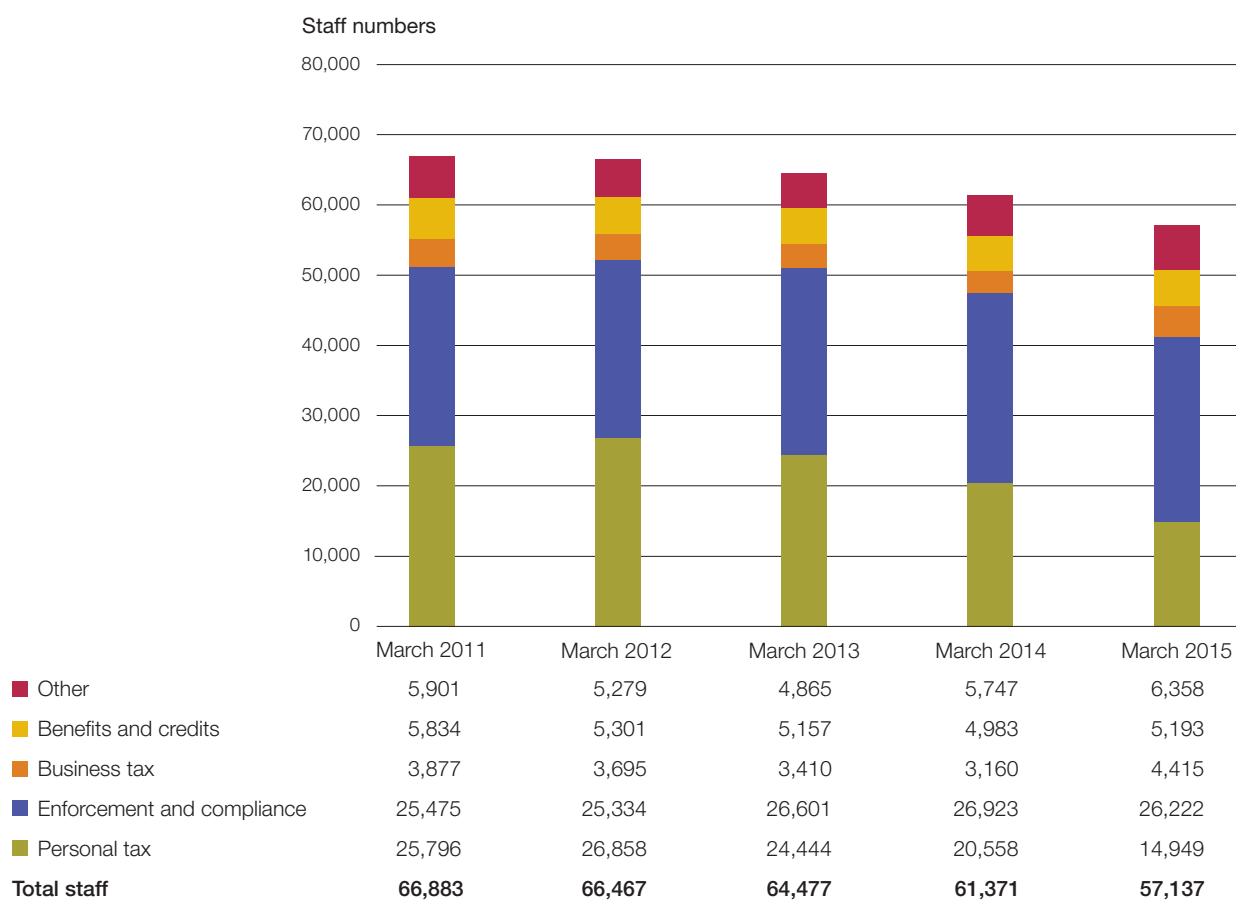
**Notes**

- 1 Benefits and credits spending includes Resource Accounts subheads: E Social benefits and grants, F Providing payments in lieu of tax relief to certain bodies, M Personal tax credits and N Other reliefs and allowances.
- 2 Administration spending is Resource Accounts subhead A HMRC administration.

Source: Analysis of HM Revenue & Customs' Resource Accounts and Trust Statement

**Figure 6**  
Staff numbers

Staff numbers (full-time equivalent) have decreased in each of the past 5 years



Source: HM Revenue & Customs data



## Part Two

### HMRC's assessment of the tax gap and tax risk

**2.1** HM Revenue & Customs (HMRC) faces many risks to the effective and efficient collection of tax. Customers vary in their abilities to understand and interact with the tax system. Most taxpayers want to get their tax right but some do not take sufficient care or may misinterpret rules. Some establish aggressive arrangements to avoid tax by exploiting loopholes in the tax rules, while others are prepared to break the law by seeking to evade tax, such as by concealing their income from HMRC. Organised criminals target weaknesses in the tax system to commit fraud, such as by triggering VAT repayments.

**2.2** HMRC seeks to assess how much of the tax due is not collected (the 'tax gap'), and to identify and quantify ongoing risks to tax revenue (tax at risk), and measure the effectiveness of its response. In this part we describe how HMRC does this and how its approach is developing. We also summarise recent reports by the National Audit Office (NAO) which have considered the effectiveness of HMRC's work to identify and address particular tax risks.

#### How HMRC estimates the tax gap

**2.3** The tax gap is HMRC's estimate of the difference between the amount of tax it should theoretically be able to collect and what it actually collects. Estimating the tax gap is not an exact science but it provides an indicator of the trend in tax compliance, and a broad indication of HMRC's long-term performance in tackling non-compliance. HMRC's business plan for 2012–2015 included an objective to close the tax gap.

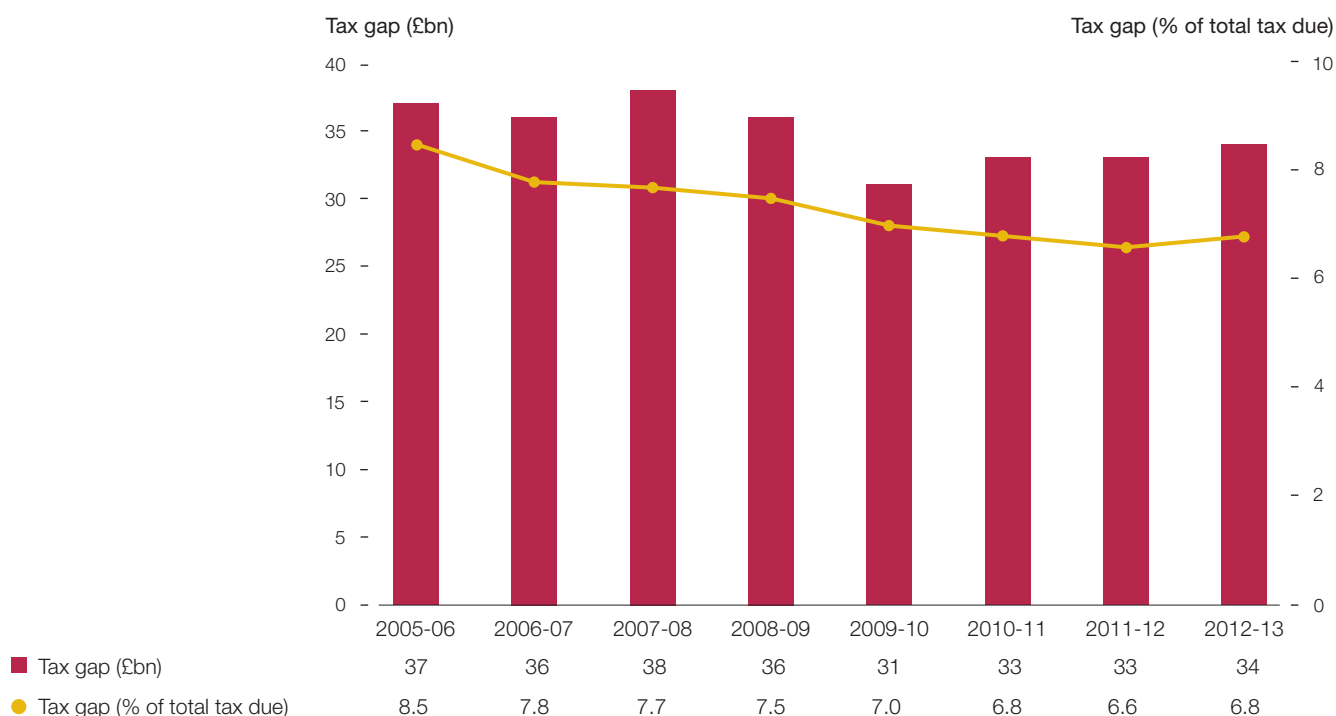
**2.4** HMRC publishes tax gap data for official statistics and prepares a report each year which sets out its methodology and analysis in detail. HMRC seeks to preserve the integrity of its tax gap methodology over time, but it also refines its methodology to make its estimates as robust as possible based on the best data available. When it makes changes, it adjusts previous years' data to preserve the time series.

**2.5** HMRC's latest estimate of the tax gap is £34 billion, covering the 2012-13 year. As a proportion of all the tax due, the tax gap decreased steadily from 8.5% in 2005-06 to 6.6% in 2011-12, increasing slightly to 6.8% in 2012-13 (**Figure 7**). Analysis of the tax gap can help HMRC understand the source of tax losses and where to focus its attention. For example, it publishes a breakdown of the tax gap by type of tax, customer group and customer behaviour (**Figure 8** overleaf). This three-way analysis mirrors the way HMRC considers tax risks and organises its compliance response.

### Figure 7

Size of the tax gap in absolute terms and as a percentage of all tax due from 2005-06 to 2012-13

HMRC's estimate of the tax gap as a proportion of all tax due declined from 2005-06 to 2011-12, but increased slightly in 2012-13



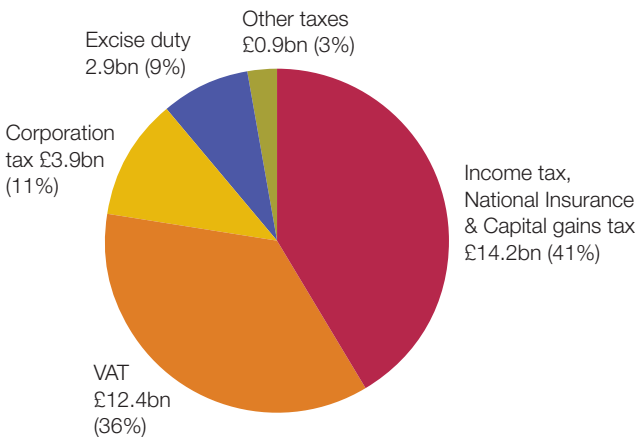
Source: HM Revenue & Customs, *Measuring tax gaps 2014 Edition*, October 2014

**Figure 8**

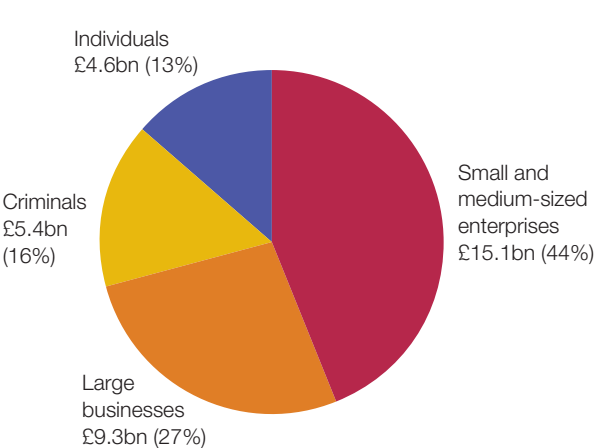
The share of the tax gap (2012-13) by type of tax, customer group and behaviour

The taxes that account for most of the tax gap are income taxes (41%) and VAT (36%), while the largest share by customer group comes from small and medium-sized enterprises (44%)

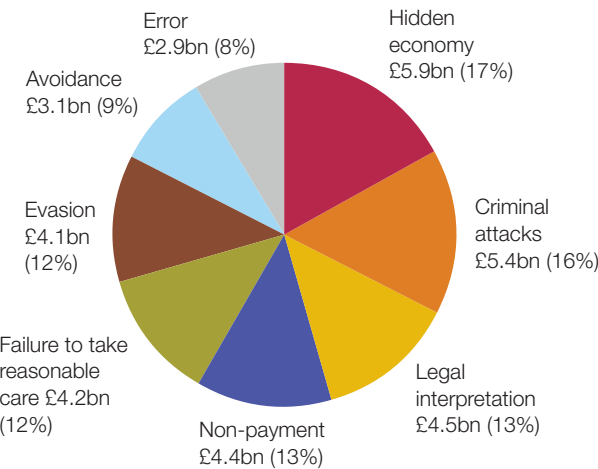
Type of tax



Customer group



Customer behaviour



Source: HM Revenue & Customs

## The tax gap methodology and its limitations

**2.6** The tax gap involves a significant time lag. Taxpayers have up to a year from the year-end to submit their tax returns and HMRC needs time to evaluate them. HMRC therefore publishes an initial estimate of the tax gap around 18 months after the end of the tax year to which it applies. Some components are projected and revised as new data become available, resulting in revisions to the tax gap measure in subsequent publications.

**2.7** The tax gap is inherently difficult to estimate and HMRC acknowledges that no estimate of the tax gap can be definitive and that its estimates carry a degree of uncertainty. It uses a mix of sources and methods to fill gaps in data (**Figure 9**). It makes ‘top-down’ estimates using national statistics for indirect taxes (VAT and excise duties). For direct taxes (on income and wealth), it applies a ‘bottom-up’ approach, making random enquiries on a sample of tax returns to estimate the size of the tax gap nationally. It also cross-checks its data with other sources, including its intelligence on tax risks. Where data is very limited, HMRC bases its estimates on known cases and makes an extrapolation. Around two-thirds of the tax gap is estimated using established methodologies, with the remainder estimated using developing and experimental methodologies.<sup>8</sup>

**Figure 9**

Sources of HMRC’s tax gap estimates by type of tax

HMRC uses a range of methods to estimate the tax gap, which vary by type of tax. Where possible HMRC cross-validates its estimates by using more than one approach.

Tax regime	‘Top-down’ estimates of tax due from macro-economic data	‘Bottom-up’ random enquiries into tax returns	HMRC’s own intelligence on tax risk	Cross-checking with other sources of data	Illustrative estimates to fill gaps in data
VAT	Yes	Yes	Yes	Yes	Yes
Excise	Yes				Yes
Income tax, National Insurance and Capital gains tax		Yes	Yes	Yes	Yes
Corporation tax		Yes	Yes		Yes
Stamp duty			Yes		Yes
Other direct					Yes
Percentage of tax gap which is estimated primarily by this method	44%	22%	8%	3%	23%

Source: National Audit Office summary of HM Revenue & Customs and International Monetary Fund analysis

<sup>8</sup> Experimental methods are used for the hidden economy, some excise duties, large and complex businesses, large partnerships, large employers, Inheritance tax and some smaller taxes.

**2.8** HMRC is not able to estimate the scale of uncertainty around its best estimate of the tax gap. For around 60% of the value of the tax gap, it has not made any estimate of the scale of uncertainty. For the remaining 40% (£14 billion) of the tax gap, HMRC can and does calculate margins of error.

**2.9** Other commentators have published estimates of the tax gap in the UK which rely on macroeconomic data to make ‘top-down’ estimates. Without access to the range of data held by HMRC, it is necessary to infer relationships from aggregated data in order to produce such estimates. They also define the tax gap differently, such as by using a much broader definition of tax avoidance than that employed by HMRC. Such approaches typically lead to much higher estimates. HMRC argues that top-down approaches are not possible for direct taxes.<sup>9</sup> Instead it uses the data it has from sources such as random enquiries, risk registers and data matching, to produce ‘bottom-up’ estimates for direct taxes.

**2.10** In 2013, HMRC asked the International Monetary Fund (IMF) to review its methodology for estimating the tax gap. The IMF concluded that HMRC produced one of the most comprehensive studies of the tax gap available internationally. It concluded that in general the methodologies HMRC used to estimate the tax gap were sound and consistent with the approaches used by other countries. It found the HMRC programme followed a pattern of employing “bottom-up” based estimates for the direct tax gaps, and “top-down” estimates for the indirect tax gaps. The IMF judged that both approaches were applied consistently with good international practices – in fact, HMRC had been leading the application of some of these methodologies.<sup>10</sup> The IMF recommended that HMRC improve its measurement and reporting of the tax gap, such as by combining ‘bottom-up’ and ‘top-down’ approaches for those taxes where this is possible, including direct taxes. It also recommended that HMRC improve its estimates of undetected non-compliance by replacing uplift factors derived from US evidence with those produced from UK data.

**2.11** No measure of the tax gap can be definitive, and there will always be uncertainties inherent in such a calculation. HMRC must also balance the cost of refining its estimate with the added value such additional work would provide. We consider it useful that HMRC has produced a measure of the tax gap as an indicator of the scale and nature of non-compliance with the tax rules, and as a broad indication of its performance over time. It is also a strength that HMRC publishes a comprehensive analysis of its tax gap estimates so that the basis and limitations of the measure are clear and understood. HMRC supplements the tax gap with more timely sources of intelligence about tax at risk to help it respond in an appropriate and timely way to known and emerging threats.

<sup>9</sup> A detailed explanation of why HMRC believes such approaches are not possible is set out in an HMRC working paper “The practicality of a top-down approach to the direct tax gap” August 2011. Available at: <https://www.gov.uk/government/publications/the-practicality-of-a-top-down-approach-to-the-direct-tax-gap>

<sup>10</sup> International Monetary Fund, *Country Report No. 13/314, United Kingdom: Technical Assistance Report – Assessment of HMRC’s Tax Gap Analysis*, October 2013.

## How HMRC assesses tax at risk

### HMRC's approach to promoting tax compliance

**2.12** HMRC uses three dimensions by which to assess the risks to tax revenue and plan its compliance response: type of tax (such as corporation tax); customer group (such as large business); and customer behaviour (such as tax avoidance or criminal attack). HMRC aims to promote tax compliance and deter non-compliance by:

- making its systems and processes easier for customers (for example, by simplifying guidance and forms);
- making it harder for people to cheat or make mistakes when they file information (for example, real-time alerts to stop repayments of VAT on fraudulent and incorrect claims); and
- responding to non-compliance firmly, and with maximum impact (for example, by targeting tax investigations on high-risk groups).

**2.13** HMRC applies different compliance strategies to different groups of taxpayers. It has dedicated customer relationship managers to support and monitor large businesses and wealthy individuals with complex tax affairs. For most customers who are required to submit tax returns, HMRC uses mass messaging to nudge customers in the right direction. It plans to help customers further in the future by pre-populating tax returns with data it holds and promoting compliance by using pop-up messages to challenge unusual entries on forms. For customers who choose not to comply voluntarily or engage with the tax system at all, HMRC must intervene more actively to detect and tackle abuses of the tax rules, sometimes working alongside other government bodies, such as local authorities and the police, sometimes working internationally with other revenue authorities and law enforcement agencies.

### How HMRC identifies and records tax risks

**2.14** HMRC identifies risks to revenue from a variety of sources including tax returns, third-party data, intelligence from the public, published accounts and social media. It analyses data to identify those parts of the taxpayer population that present particular risks and individual taxpayers with a high risk profile. HMRC has a range of tools to analyse data: its Connect technology, for example, checks tax returns against multiple data sources to detect patterns, hidden relationships and inconsistencies, and suspicious activity. HMRC believes Connect has enabled it to produce a higher volume of better quality cases to compliance officers whilst also reducing the number of staff working on production of those cases by 40%.

**2.15** HMRC analyses the intelligence it has about tax risks with other relevant information and trend data, such as by analysing seasonal patterns to help understand changes in tax revenue. It assesses which risks are most likely to materialise, which helps inform decisions about how to intervene, such as by creating a specialist taskforce.

**2.16** HMRC records the main risks to tax revenue in risk registers which are discussed on at least a monthly basis by the teams which administer each tax. Cross-cutting planning and governance groups oversee the response to strategic risks to tax compliance, such as from marketed tax avoidance or off-shoring. HMRC normally pilots new interventions on a small scale before committing significant resources. The planning groups monitor the cost of interventions and their effectiveness, and advise the business on how best to deploy resources to achieve the optimal impact.

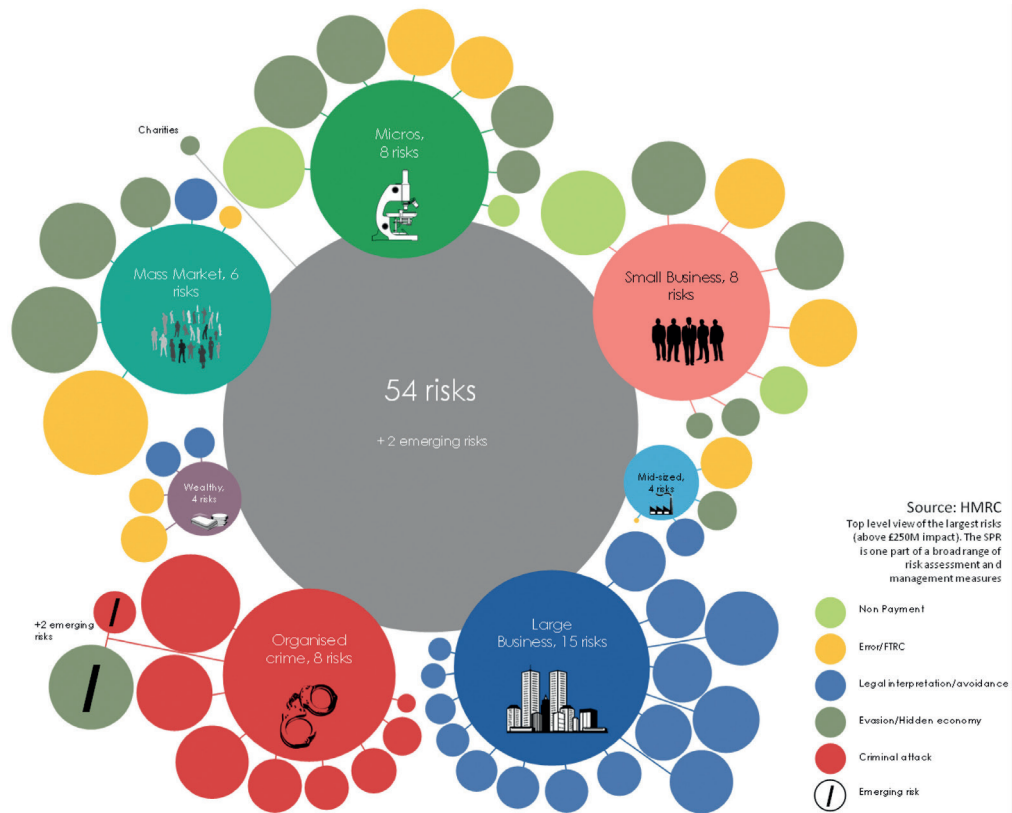
### How HMRC is developing a more strategic view of tax risk

**2.17** In his report on HMRC's 2013-14 Accounts, the Comptroller and Auditor General (C&AG) concluded that HMRC's assessment of tax risks needed to be used more consistently in the allocation of compliance resources. He noted that HMRC was developing the Strategic Picture of Risk to bring together data, intelligence and economic analysis to give a more comprehensive and current view of risks across its business, intending to provide a more explicit link between risks and decisions about where to allocate resources.

**2.18** The Strategic Picture of Risk combines all risks to tax exceeding £250 million with risks to the integrity of the tax system or HMRC's reputation for running it. HMRC has identified 54 such strategic risks which, if realised, have the potential to lead to £48 billion in lost tax revenue (**Figure 10**). The Strategic Picture of Risk is not intended to determine how HMRC allocates resources to tackle non-compliance, but is becoming an important tool in influencing such decisions. HMRC recognises the data has limitations and is developing the measure and seeking to use it more consistently to inform operational decisions.<sup>11</sup>

**2.19** HMRC is now seeking to assess how much of the tax gap is attributable to each strategic risk and how much of the related tax is collected from its compliance interventions. This requires HMRC to apportion its estimates of compliance yield (discussed in Part Three) to each of the strategic risks, a process which remains immature but which HMRC is refining. It has apportioned 76% of compliance yield to the strategic risks where it can identify a clear link. In other cases, it has not apportioned yield to the risks, either because the yield does not relate to one of the 54 strategic risks or because it is not clear what risk it should relate to. HMRC has estimated that its compliance work to mitigate the strategic risks recovered at least £14 billion in tax revenue in 2013-14.

**Figure 10**  
HMRC analysis of risks by market segment and behaviour



Source: HM Revenue & Customs



## What the data show

**2.20** HMRC's preliminary analysis shows that some risks are inherently much harder to tackle than others (**Figure 11**). This is unsurprising: for example, large businesses are more visible and easier for HMRC to influence than criminals or participants in the hidden economy. The proportion of the tax gap which HMRC estimates is closed by its compliance work is:

- high for most of the risks relating to legal interpretation and tax avoidance by large businesses;
- low for those risks relating to very small businesses and the hidden economy; and
- widely distributed in relation to risks from evasion and criminal attack.

**2.21** For each strategic risk, we reviewed HMRC's estimate of the tax yield from its compliance work against its estimate of the potential value of the tax at risk. We identified 13 risks with a potential value of more than £1 billion for which HMRC's analysis suggests it had reduced the potential tax loss by less than a quarter. Of these risks:

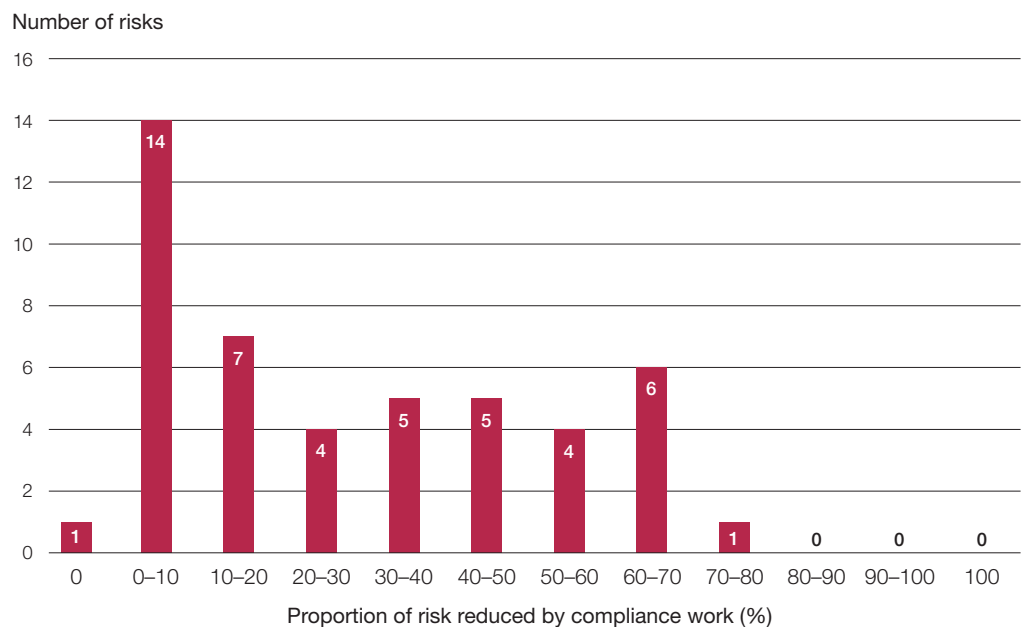
- 9 relate to micro or small businesses;
- 8 relate to income tax (of which 6 relate to self-assessment); and
- 6 relate to tax evasion and the hidden economy.

**2.22** HMRC's analysis of the Strategic Picture of Risk so far has identified 3 priority areas into which HMRC has commissioned deeper reviews: the micro business sector, mid-sized business and wealthy individuals. The micro-business sector, for example, accounts for several strategic risks involving evasion and income tax. HMRC's review of the micro-business sector made 10 recommendations, including several areas for further research, making more use of customer data, promoting easier payment and reviewing HMRC's powers.

**Figure 11**

Distribution of strategic risks by the proportion by which the risk is reduced by compliance work

Given the wide range of risks HMRC faces, some risks are inherently much harder to tackle than others. This is illustrated by the variance in the HMRC's estimates of the proportion of risk reduced by compliance work

**Note**

1 HMRC cannot yet apportion compliance yield to 7 of its strategic risks.

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

## What further analysis is needed

**2.23** More systematic and deep analysis of risks is necessary to understand whether levels of yield are because of the inherent nature of the risks or because of the effect of HMRC's interventions. HMRC does seek to identify how vulnerable the tax system is to each risk and how challenging its compliance controls are. It is intending to introduce analysis on the inherent challenge of closing risks and the effectiveness of related controls into the Strategic Picture of Risk. As HMRC deploys new techniques, such as increasing its mass messaging to nudge taxpayers in the right direction, it needs to develop suitable measures to understand their effectiveness. This requires a different methodology from that used by HMRC to record the tax yield from more traditional compliance work, such as that done by teams investigating potential tax avoidance and evasion cases, where the money recovered by the team is more readily identifiable.

**2.24** For some risks, HMRC has sought to compare the overall amount of resources deployed with the tax yield collected. We looked at HMRC's analysis in respect of 3 types of risk, arising from: self-assessment of income tax; the mid-sized business sector; and evasion. We found that HMRC knew the amount of resources it devotes to the risks for self-assessment and mid-sized business, but did not have complete data on the resources devoted to tackling evasion risks. Estimating the costs of evasion work can be complicated because cases typically involve investigating a range of issues, of which the possibility of tax evasion is just one.

**2.25** HMRC's analysis for mid-sized business suggested potential to improve the allocation of resources. It identified, for example, that compliance interventions targeting excise risks for mid-sized business consumed very little resource but supplied 20% of the expected yield for the sector; but that in contrast, compliance interventions focused on employers consumed 21% of resources but offered only 8% of expected yield. There are other factors which must also be considered when assessing the distribution of resources, such as the need to tackle the scale of the tax gap in a particular area and the need to maintain a deterrent effect.

### **NAO work examining HMRC's response to risk**

**2.26** NAO's work over the last Parliament found that HMRC has been successful in increasing overall levels of revenue, particularly where it has targeted specific risks by applying additional compliance resources. However, our work has also shown that HMRC commits the majority of its compliance resources to investigating non-compliance and rule-breaking after the event, from which its rates of return – given the wide variety of risks HMRC manages – are variable. Such investigative work is important to act as a deterrent, but HMRC is seeking to combine this approach with an increasing range of preventative compliance measures. We have recommended changes which have helped HMRC increase the efficiency and effectiveness of its compliance work by helping it to intervene earlier in the cycle (**Figure 12** on pages R35 and R36).

**2.27** For example, HMRC has responded to the work of the NAO and the Committee of Public Accounts by seeking and applying new powers, which it expects will disrupt the industry of marketed tax avoidance; and by piloting new interventions to prevent erroneous or fraudulent payments happening in the first place, such as by analysing the root causes of error and fraud in the payment of tax credits (Part Five). We have also made recommendations about how HMRC could improve its detection of risks and decision-making about how to deploy its resources. In February 2015, we reviewed HMRC's response to our and the Committee's recommendations since 2010 and found that HMRC had accepted and implemented most recommendations.

**2.28** As HMRC develops its use of the Strategic Picture of Risk, we intend to report on how effectively its new approach to assessing tax risks drives operational decisions about how to deploy compliance resources. In addition, we plan to evaluate and advise Parliament specifically on how effectively HMRC is identifying and tackling tax evasion, the hidden economy and criminal attack on the tax system, which account for 45% of the tax gap.

**Figure 12**

## National Audit Office work examining HMRC's response to risk

Subject	Date	Conclusions
Renewed alcohol strategy – a progress report	January 2012	Alcohol excise fraud is a significant risk to revenue. We found HMRC had exceeded its financial objective in delivering its alcohol strategy, but needed to improve the effectiveness of its work with industry to disrupt the supply chain for alcohol diverted illicitly to the UK market. We also recommended HMRC should strengthen the financial and performance information is used to inform delivery of the strategy.
The Compliance & Enforcement programme	March 2012	This change programme helped HMRC substantially increase compliance yield with fewer staff. It introduced new technologies to strengthen compliance work, including its approach to assessing risks. We acknowledged that HMRC was working to exploit the full potential of new capabilities and recommended that it integrate the new systems into business processes and ensure staff have the capabilities to use new technologies.
Tax avoidance: tackling marketed avoidance schemes	November 2012	It is inherently difficult for HMRC to stop tax avoidance as it is not illegal. Since requiring taxpayers to disclose their use of tax avoidance schemes, HMRC had made important headway by reducing loopholes and opportunities for avoidance. This had changed the shape of the market but not prevented some promoters selling highly contrived schemes and depriving public finances of billions of pounds. We recommended HMRC should: <ul style="list-style-type: none"> <li>● seek more effective counter-measures, proposing legislative change where necessary;</li> <li>● analyses the economics of promoting and operating avoidance schemes, the incentives and potential disincentives for promoting schemes, and the types of interventions that could change behaviour; and</li> <li>● improve its management information and costing of its activities to better direct its anti-avoidance work.</li> </ul>
Tackling tax credits error and fraud	February 2013	HMRC had been innovative in tackling fraud and error. It had improved its understanding of risks to strengthen its operational response, piloting different approaches. This led to a year-on-year improvement in the amount of error and fraud prevented, and reduced losses in 3 of 6 risk areas. Our recommendations focused on the actions needed to achieve a sustainable reduction in fraud and error. We recommended that HMRC improve its use of data and analytical techniques to establish plans for each risk area, and improve the quality and volume of its interventions.
Progress in tackling tobacco smuggling	June 2013	HMRC's renewed strategy for tackling tobacco smuggling had set out a wide range of complimentary measures to tackle the problem, but its approach to deterring and disrupting the distribution of illicit tobacco was not yet effectively integrated. HMRC's focus on building overseas intelligence was yielding success. We recommended HMRC should: <ul style="list-style-type: none"> <li>● assess the deterrent impact of enforcement action against people selling illicit tobacco;</li> <li>● collaborate further with police, trading standards and other local bodies, building on successful regional initiatives; and</li> <li>● seek to improve its methodology for estimating tax losses from tobacco fraud.</li> </ul>

**Figure 12** *continued*

## National Audit Office work examining HMRC's response to risk

Subject	Date	Conclusions
Tackling VAT fraud (Part Three of the C&AG's report on HMRC's 2012-13 Accounts)	July 2013	HMRC made good use of intelligence to respond to the risks. HMRC's interventions and wider cooperation had helped reduce significantly VAT losses from missing trader fraud from between £2 billion and £3 billion in 2005-06 to an estimated £0.5 billion to £1 billion in 2010-11. We recommended HMRC should consider the costs and benefits of enhanced real-time risk profiling of VAT payment returns, and should increase the urgency of its response to the fraud risk posed by internet-based traders.
How HMRC resources compliance work (Part Three of the C&AG's report on HMRC's 2013-14 Accounts)	July 2014	HMRC used £1 billion of additional funding between 2011-12 and 2014-15 to target specific risk areas and increase tax revenues. It was constrained in how flexibly it could reallocate resources but had responded to changing threats to tax revenue by shifting the balance of its activities. We recommended that HMRC could further improve its strategic planning process by using its assessment of risks to explicitly inform the deployment of resources, and build a view of the optimal deployment of resources by risk type.
The effective management of tax reliefs	November 2014	HMRC needed more structured and proactive management of tax reliefs, an area with significant impact on public finances. We found some good practice but that HMRC did not generally test whether tax reliefs achieved their aims. We identified risks that tax reliefs could cost more than expected; could be used in ways not intended by Parliament; and could fail to bring about the intended behaviour change. We recommended HMRC should systematically track the actual costs of tax reliefs against their forecasts, and report to Parliament each year on the cost and impact of the tax reliefs posing the greatest risks.
Increasing the effectiveness of tax collection: a stocktake of progress since 2010	February 2015	HMRC is among the strongest government departments as regards its managerial competence and its robustness in managing the risks to its essential function of tax collection. It engaged strongly with the accountability process, taking a robust approach to implementing the recommendations of the NAO and the Committee of Public Accounts. In tackling marketed tax avoidance, it had sought and obtained new powers and implemented new measures appropriately to tackle some of the root causes of abuse of the tax system. It now faced some significant challenges, however, if it was to harness technology effectively and thereby exploit the data it collects to continue to improve the efficiency and effectiveness of its tax collection activities.

Source: National Audit Office publications

# Part Three

## Measuring compliance yield

### Compliance yield

**3.1** The 2010 Spending Review set HM Revenue & Customs' (HMRC's) funding and delivery commitments until 2014-15. HMRC committed to make efficiency savings while doing more compliance work to secure additional revenues. HMRC's efficiency savings would reduce its running costs from £3.4 billion in 2010-11 to £3.1 billion in 2014-15. At the same time, it would increase the additional revenue from its enforcement and compliance work by £7 billion a year by 2014-15. HM Treasury agreed that, to achieve this additional revenue, HMRC could reinvest £917 million of its efficiency savings.

**3.2** In 2014-15, HMRC reported its highest compliance yield to date – some £26.6 billion (£23.9 billion in 2013-14), meeting its target of £26.0 billion (£23.0 billion in 2013-14).

**3.3** Building on the work we undertook in 2013-14, this Part considers HMRC's progress in taking forward our recommendations and those of the Committee of Public Accounts. It assesses whether HMRC's methodology supporting the yield calculations for 2014-15 is robust. We have not verified the accuracy of the figures reported by HMRC.

### The measure

**3.4** HMRC measures compliance yield to support accountability and its own decision-making. It evaluates the additional revenues it considers it has generated, and the revenue losses it has prevented, from its enforcement and compliance activities. This yield is a more direct and timely measure of the impact of HMRC's enforcement and compliance activities than the tax gap, which is subject to long reporting delays and other factors outside HMRC's control (see paragraph 2.6).

**3.5** Compliance activities can take many different forms, such as disrupting organised criminal gangs or tackling the use of tax avoidance schemes. But it can be divided into activities that are:

- detective and corrective – these take place after a taxpayer has taken a course of action, for example when HMRC checks a taxpayer's self-assessment return against data it already holds so that the taxpayer eventually pays the correct amount of tax due; and
- preventative – these take place before a taxpayer acts; for example, the government may change legislation to close tax loopholes so that taxpayers find it harder to exploit any weaknesses in the law.

**3.6** HMRC has continued to develop how it measures its yield from compliance activities over the 2010 Spending Review period to reflect the impact of its wide range of existing and new compliance work. It has progressively adapted the measure to reflect changes in its compliance activities and has improved the evidence base to support its estimates of the impact of these activities. As it has evolved the measure, HMRC has taken a prudent approach, collecting relevant evidence before making changes and reducing its estimates appropriately where there is uncertainty.

### **Our work in 2013-14**

**3.7** We reviewed the methodology HMRC had in place to support its yield estimates.<sup>12</sup> We noted that the methodology and processes HMRC used to estimate compliance yield in 2013-14 were sound, and that the measure provides a reasonable proxy for the beneficial impacts of its compliance work.

**3.8** However, our work revealed significant errors in the baseline calculation.<sup>13</sup> To measure incremental improvements over the Spending Review period, HMRC established a baseline based on its 2010-11 performance. It gave a fixed point of reference from which HMRC could set and amend targets and measure performance over the 2010 Spending Review period. HMRC adjusted the baseline in its 2013-14 Annual Report so it could measure its performance since 2011-12 against a comparable baseline. Despite the baseline adjustment, HMRC still met the additional compliance yield targets that the government set in the 2010 Spending Review.

**3.9** While we found that HMRC's internal processes for testing and challenging in-year estimates were sound, HMRC did not pick up the error in the 2010-11 baseline for three years. It accepted that there should be external scrutiny of the data published and invited the NAO to play an ongoing role in providing independent assurance about the data's quality.<sup>14</sup> Following its hearing on 16 July 2014 where it considered HMRC's published Annual Report and Accounts for 2013-14, the Committee of Public Accounts recommended that HMRC improves the governance around the measure and how it is publically reported (**Figure 13**).<sup>15</sup>

### **HMRC's performance in 2014-15**

**3.10** HMRC's current measure of compliance yield is complex. It is a combination of measures, calculated in different ways and covering different time periods. These are designed to reflect the breadth of its compliance activities, which can be difficult to quantify. As a result, they include an element of estimation, particularly in assessing the impact of HMRC's activities on customers' future behaviours.

<sup>12</sup> Comptroller and Auditor General, *HM Revenue & Customs Annual Report and Accounts 2013-14*, HC 19, July 2014, Part Two, pp. R19–R32.

<sup>13</sup> See footnote 12, pp. R21–R22, paragraphs 2.5–2.14.

<sup>14</sup> See footnote 12, page R27, paragraph 2.30.

<sup>15</sup> HM Treasury, Treasury Minutes, *Government responses on the Eighteenth, the Twenty-First to the Twenty-Fourth, and the Thirty-Third reports from the Committee of Public Accounts: Session 2014-15*, Cm 9013, February 2015.

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**Figure 13**

## Committee of Public Accounts' recommendations

**HMRC should ensure the governance arrangements around its key performance indicators are sufficiently robust, and subject to adequate internal and external challenge, before they are reported publicly:** The government agreed with this recommendation, setting out that HMRC's internal audit function and the National Audit Office have programmes of work in place for 2014-15. HM Treasury will also have greater oversight of HMRC's compliance revenue.

**HMRC should be more transparent about its compliance yield estimates by publishing more detail about how it calculates yield, being clearer about how much it has actually collected in cash terms and explaining how uncertainty affects its estimates:** The government agreed with this recommendation and recognised the need to provide more information to aid understanding of its complex performance. HMRC will continue to provide explanatory information whenever it publishes its compliance revenue outturns.

**HMRC should maintain a comparable measure of compliance yield over time and report clearly the impact of any changes it makes to its methodology in its key accountability statements to Parliament:** The government disagreed with this recommendation. While it will ensure that any changes are set out clearly in its Annual Report, it said it may not always be possible, or practical, to make comparisons over time. This is because HMRC's method of assessing the effects of its compliance activities may change so significantly that it would be unable to maintain a comparable time series.

Source: HM Treasury, Treasury Minutes, *Government responses on the Eighteenth, the Twenty-First to the Twenty-Fourth, and the Thirty-Third Reports from the Committee of Public Accounts: Session 2014-15*, Cm 9013, February 2015, pp. 3-4.

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**3.11** HMRC's reported compliance yield in 2014-15 was £26.6 billion (**Figure 14** overleaf). This has five components:

- **Cash collected** of £9.8 billion (37%), which is an estimate of the extra tax HMRC expects to collect by identifying and challenging non-compliance.
- **Revenue losses prevented** of £7.9 billion (30%), which is tax revenue HMRC has protected each year either by refusing or reducing repayment claims because they are in error or fraudulent or by disrupting organised criminal activity.
- **Future revenue benefit** of £6.7 billion (25%), which is HMRC's estimate of the revenue benefits over the next 1 to 5 years where it considers it has changed the behaviour of taxpayers.
- **Product and process** yield of £1.3 billion (5%), which is the annual impact of legislative changes made since April 2011 to close tax loopholes and changes to HMRC's processes which reduce opportunities to avoid or evade tax.
- **Accelerated payments** of £0.8 billion (3%), a new component this year, which is the net amount of disputed tax (£0.6 billion) that users of avoidance schemes have paid upfront to, and have received back from, HMRC and £0.2 billion of estimated behavioural impact. We give our view on the method applied to calculating this yield in paragraphs 3.18 and 3.19.



**Figure 14**

## Compliance yield reported by HMRC since 2011-12

HMRC reported £26.6 billion of compliance yield in 2014-15, more than in any previous year of the 2010 Spending Review period

**Note**

1 Percentages shown here do not all add to 100% due to rounding.

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

**3.12 Figure 15** shows examples of HMRC's compliance activities and how they result in different types of yield.

## Figure 15

### Examples of HMRC's interventions and their impact on the reported yield

Directorate	HMRC intervention	Reported yield
Personal tax	<p>An executor submitted an IHT400 form for the estate of their late relative. HMRC noticed that two properties owned by the deceased appeared to have been undervalued. HMRC referred the matter to the Valuation Office to establish correct values.</p> <p>HMRC opened an enquiry, as internal information suggested the deceased was receiving foreign rental income. He had declared this through his self-assessment return, but no foreign property was included on the IHT400 form. HMRC established that the deceased owned a property in France, which had not been declared.</p> <p>The Valuation Office advised HMRC that the two UK properties owned by the deceased had been undervalued by £50,000.</p> <p>HMRC also made enquiries about gifts the deceased may have made during his lifetime. These enquiries revealed the deceased gave gifts of £150,000 to each of his three children.</p>	<p>HMRC's compliance check resulted in reported yield of:</p> <ul style="list-style-type: none"> <li>• £20,000 of <b>cash collected</b> to reflect the extra tax payable as a result of the UK properties being undervalued by £50,000.</li> <li>• £77,546 of <b>cash collected</b> to reflect the extra tax payable on the discovery of a foreign property uncovered as a result of the compliance investigation.</li> <li>• £180,000 of <b>cash collected</b> to reflect the tax payable on the £450,000 of gifts the deceased made just before he died.</li> </ul>
Business tax	<p>The tax agent of a company advised HMRC that there is no annual tax on enveloped dwelling (ATED) liability for their client, as the company owned the property as a beneficiary of a settlement. HMRC asked for information to establish if this claim was correct.</p> <p>The agent eventually accepted that ATED was due.</p>	<p>HMRC reported <b>revenue loss prevented</b> of £15,000 and <b>future revenue benefit</b> of £30,800 for two years.</p>
Business tax	<p>After a business submitted its company tax return, HMRC investigated whether all the interest paid on a £1 billion loan is an allowable deduction for tax.</p> <p>HMRC found that part of the interest paid was non-commercial as the loan was from a related non-UK company that had lent more money than a commercial bank would have done. This meant not all of the interest was an allowable deduction.</p>	<p>HMRC reported:</p> <ul style="list-style-type: none"> <li>• <b>Cash collected</b> of £6.9 million, which is the tax on the disallowed interest on part of the loan in the first year of the loan.</li> <li>• <b>Future revenue benefit</b> of £30.3 million for additional tax on future disallowances of interest.</li> </ul>
Business tax	<p>A business submitted a VAT return claiming a repayment. The return was selected by HMRC for review.</p> <p>HMRC found that an invoice for business entertainment had been included in the return. VAT on this cannot be recovered.</p>	<p>HMRC's action results in £250,000 of <b>revenue loss protected</b> as the £250,000 VAT claimed was not repaid to the business.</p>
Enforcement and compliance	<p>HMRC stopped an organised crime gang's attempt to evade excise duty by smuggling loose leaf tobacco into the UK and processing it to convert into counterfeit hand-rolling tobacco.</p> <p>Four individuals were successfully prosecuted and given custodial sentences totalling 11 years and three months. All were found to be illegal immigrants and two have received deportation orders.</p>	<p>HMRC's investigation yields £8.3 million in <b>revenue loss prevented</b>, which is an estimate of the continuing losses that would have occurred over the next 12 months if HMRC had not stopped this fraudulent activity.</p> <p>Cash believed to be the proceeds of crime with a value of nearly £16,000 was taken from the gang and forfeited to the Crown. Confiscation proceedings are ongoing.</p>

### **Our assessment of the 2014-15 measure**

**3.13** In assessing the robustness of HMRC's method of estimating its yield, and the extent to which it has taken forward the recommendations that we and the Committee of Public Accounts made last year, we considered whether the measure:

- is based on the best evidence available;
- is reported in a transparent way;
- allows comparison of HMRC's performance over time; and
- is subject to robust processes to assure data quality.

**3.14** Our analysis is at **Figure 16** on pages R43 and R44. Our findings fall into four areas:

- estimation and uncertainty;
- internal consistency;
- transparency in reporting; and
- data quality.

**Figure 16**

## Types of compliance yield and how they are scored

Yield type	When the revenue benefit occurs	What is measured	Benefits received by the Exchequer in year	Levels of estimation included within the yield calculation	NAO's assessment of the robustness of HMRC's methodology
Cash collected £9.8 billion	In-year	Additional tax liabilities and behavioural penalties are recorded when the compliance officer issues the taxpayer with a statement of the tax due.	Yes.  Some benefits, in terms of cash, will be received in year, however some will be outstanding, and some will never be received.	HMRC discounts a proportion of the amount it records by 10% to recognise that some tax liabilities are not collected, for example because the taxpayer becomes insolvent.	Reasonable, but some weaknesses.  Recording cash collected is straightforward. The area for improvement is the application of a discount rate, where the evidence base could be developed. HMRC analysis in previous years broadly indicated that 10% is not unreasonable. HMRC has performed additional work this year, as part of a longer term approach to improve the evidence base behind cash collection rate. HMRC recognises that more work is needed to fully support the 10% discount rate.
Revenue losses prevented £7.9 billion	In-year and future	Losses prevented are recorded when HMRC refuses or reduces repayment claims because they are incorrect or fraudulent (84% of revenue losses prevented in 2014-15).  However, HMRC estimates the value of criminal activity disrupted when it seizes illicit goods (this is some 16% of revenue losses prevented in 2014-15).	Cash loss is prevented.  Future benefit expected from disruption of organised criminal gangs.	No estimation.  Amounts scored reflect specific amounts identified.  Significant estimation.  Judging the scale of a gang's activities or that individuals will go on to buy legitimate goods involves estimation.	Reasonable.  It is straightforward and well understood. The benefit to the Exchequer is clear and specific.  Methodology contains some weaknesses. Amounts scored are based on cases and the revenue that would have been lost if the criminal activity had not been successfully disrupted. This scoring assumes that none of the revenue loss relating to the particular gang that has been disrupted has been displaced to rival gangs or different criminal activities. HMRC could do more to validate this assumption.

**Figure 16** *continued*

## Types of compliance yield and how they are scored

Yield type	When the revenue benefit occurs	What is measured	Benefits received by the Exchequer in year	Levels of estimation included within the yield calculation	NAO's assessment of the robustness of HMRC's methodology
<b>Future revenue benefit</b> <b>£6.7 billion</b>	Future years (1 to 5 years)	Whenever a compliance investigation is concluded, staff assess whether, and for what period, they should record the revenue benefits that will accrue in future years.	None.  Relates to future years so no benefit received in year. But the current year's tax payments include the ongoing impacts of compliance activity completed in previous years.	Significant estimation.  HMRC estimates how long the taxpayer's behaviour will change and the likelihood and duration of impact in terms of the estimated monetary amount that will accrue over the period the future revenue benefit is being claimed for as a result of the intervention, based on the taxpayer's characteristics and circumstances.	Not straightforward and at risk of being subjective.  Whenever a compliance investigation is concluded, staff assess whether, and for what period, they should record the revenue benefits.  HMRC recognises the risk that the estimates of future revenue benefit entail a degree of uncertainty. It has established guidance for staff that explains how they should estimate the yield.  HMRC has also put limits in place on the number of years a caseworker can score an impact. They are required to have evidence of the taxpayer's commitment to change and information to support amounts scored.
<b>Product and process</b> <b>£1.3 billion</b>	In-year	HMRC records the likely impact on revenues over up to 5 years of legislative changes. Each year, it reviews these estimates and records the cumulative impact of all changes made since April 2011 as they impact the reporting year.	Yes.  Additional benefits are expected as a result of all legislative changes since April 2011 in that year.	Significant estimation.  The impact of the legislative changes is a significant estimate.	Reasonable.  The calculation of amounts is subject to external review by the Office of Budget Responsibility (OBR) and supported by appropriate documentation.
<b>Accelerated payments</b> <b>£768 million (including £200 million of behavioural impacts)</b>	In-year and future	HMRC records the disputed tax when it has been collected from tax avoidance users.  It scores repayments made by HMRC to taxpayers when a case is settled.  In addition, it scores the impact the scheme has on the behaviour of individuals in the future.	There is a net impact for the Exchequer in year with receipts and payments in respect of this scheme.  There is no in year impact for the Exchequer for the impact of the change in behaviours.	No estimation.  Actual cash received and paid out is scored.  Estimation.  The impact on individual's behaviour is estimated.	Accelerated payments is a new power which HMRC has available to it and the measure of its success is included in the compliance yield targets HMRC has been set this year. As such, it is reasonable to compare outturn against this target. HMRC will keep the way this scheme is scored under review as this initiative becomes more significant (paragraphs 3.18 and 3.19). The calculation of the behavioural impact of the accelerated payments legislation is subject to review by the OBR.

## Estimation and uncertainty

**3.15** HMRC did not design compliance yield to be a cash-based measure. It measures the outcome of the range of compliance activities HMRC undertakes, and consequently includes a degree of estimation. For example, **future revenue benefit** is an estimate of the amount of money that HMRC expects to receive in future years as a direct result of its compliance activity. HMRC takes into account the likelihood of non-compliance continuing, and the level of future monitoring. Due to the volume of cases and the range of taxes and duties potentially involved, HMRC is unable to match cash received to compliance yield cases and, therefore, cannot with certainty say how much cash is ultimately collected against all compliance interventions.

**3.16** HMRC's reported compliance yield is an attempt to reflect the full extent of its compliance activities. With around 900,000 compliance interventions across all customer groups and taxes, HMRC considers it would be neither practical nor cost effective to manually reconcile the amounts claimed to the actual amounts paid. As such, its performance measurement system includes a degree of reliance on estimates and assumptions.

**3.17** We noted that the methodology and processes HMRC used to estimate compliance yield in 2013-14 were sound. However, in reviewing HMRC's progress this year, there are areas where the evidence used to support estimates need to continue being reviewed and strengthened. **Cash collected** is a calculation of the cash HMRC expects to receive when it has identified taxpayers who have not complied with what is expected of them. It applies a discount rate to reflect that some cash will not be collected from some customer groups, for example small businesses. HMRC has consistently applied a 10% discount rate over the Spending Review period to a proportion of cash collected. Whilst we have no evidence to show that this is unreasonable, we will continue to look to HMRC to strengthen its evidence base to support this discount.

**3.18** In 2014-15, HMRC included, for the first time, the potential impact of its **accelerated payment scheme** within its yield target, agreed with HM Treasury. HMRC's performance against this target is included as a new yield type so that readers can identify the yield received against the target set. The scheme allows HMRC to collect disputed tax from the users of tax avoidance schemes up front, although it is possible for HMRC to repay this money if disputes are found in favour of the taxpayer. HMRC currently estimates that it may win around 80% of such cases, with many more settling before reaching litigation.

**3.19** HMRC reports the cash amounts it has received under this scheme during the year (some £596 million in 2014-15), and the cash amounts it has repaid (£28 million). This is a simple approach which does not involve any estimation. However, there is no adjustment for the possibility that cash received in individual cases may have to be repaid in future years, or for the possibility that the final award to HMRC may be higher than the cash already received. Although HMRC is confident that these two issues may offset each other in a particular financial year, as amounts received under the scheme are recognised up front, HMRC's current treatment may lead to its annually reported performance being distorted. HMRC will keep the assumptions supporting its approach to scoring Accelerated Payment yield under review and consider the possibility of making such adjustments once it has more of a track record of dealing with cases.

### Internal consistency

**3.20** HMRC's compliance activities cover a wide range of activities, which are reflected in the different yield types. The various types of yield are not scored consistently, although they are based on approaches set out at the start of the Spending Review period and have been consistently applied year-on-year:

- We highlighted last year that HMRC scores the total impact for **future revenue benefit**, which relates to monies it expects to collect in future years, in the year it is identified. However, it scores the impact of **product and process yield** in the year it relates to so future years are scored in the future and not in the year the impact is identified.
- HMRC reports **product and process** yield on a cumulative basis as more product and process improvements are introduced. This means the upwards trend is partly a consequence of this scoring policy; it does not necessarily indicate better performance year-on-year. This is the only yield category where HMRC applies this approach.

### Transparency in reporting

**3.21** HMRC continues to improve the accuracy, clarity and transparency of the way it reports compliance yield in its Annual Report. It has made a number of improvements in its 2014-15 reporting. For example, to allow comparability between years, it has highlighted new areas introduced into the measure this year with a breakdown of the targets over the 2010 Spending Review period it has to meet against actual outturn. It has provided further indications of the degree of uncertainty involved in its reported compliance yield, particularly in relation to its cash collected category.

**3.22** HMRC has improved its reporting of compliance yield to assist the readers of the Annual Report in comparing its performance between years. The Annual Report discloses two areas included within its yield measure in 2014-15:

- Its compliance yield target was adjusted by some £0.4 billion to take into account the impact of accelerated payments and, consequently, the yield includes the outturn performance of this policy (a net cash figure of some £568 million and £200 million of behavioural impact to reflect the deterrent effect of the accelerated payments legislation).
- The impact of one of its Spending Review reinvestment projects to increase its debt collection activity was excluded from the yield calculation in 2013-14 due to a delay in the availability of the underlying data (an estimate was included in the calculation in 2011-12 and 2012-13). The impact of this work added some £576 million to the yield figure.

These components total some £1.3 billion or 48% of the reported increase in yield from 2013-14 to 2014-15.

**3.23** Following its hearing on the Annual Report for 2013-14, the Committee of Public Accounts highlighted that HMRC should provide more information to aid the reader's understanding of HMRC's performance. The Committee recommended that HMRC should publish more detail about how it calculates yield, be clearer about how much it has actually collected in cash terms, and explain how uncertainty affects its estimates. HMRC has continued to develop the evidence base for the estimates used and has published more detail about how it calculates yield in its Annual Report for 2014-15, such as by explaining uncertainty in its estimates of 'cash collected'. However, the measure was not designed to track the amounts HMRC reports as yield to the benefits the Exchequer received in the current year and a significant element of the yield calculation relies on estimates of current and future benefits. It is therefore important that the reader is clearer that the yield is not a cash figure and the inclusion of ranges around the estimated elements of yield would help to achieve this.

### Data quality

**3.24** We reviewed HMRC's internal processes in place during 2014-15 for assuring the robustness of the data feeding into its yield calculations. As in 2013-14, we found that these were well developed and applied reasonably consistently within HMRC. Overall, there are control procedures in evidence across directorates. HMRC employs a wide range of internal checks that operate within lines of business and at a central level to ensure the quality of their data.



**3.25** However, our work highlighted that:

- There were some areas within HMRC where its quality assurance processes were weaker, increasing the risk of errors in the data. The variations in the robustness of the quality assurance processes across the lines of business sometimes reflect the differing nature of risks and volume of cases handled by each area. However, there is scope to develop and draw on processes already established by other business areas, particularly where there is no formal manager review of cases.
- In some cases, HMRC could not, without a considerable investment of time and resources, produce a full list of cases that constituted its yield figure. HMRC could, in principle, use the outcomes of its internal checks of cases to determine the net impact of identified errors on its reported compliance yield. This would improve the quality of the management information available to HMRC. HMRC believes that its current checks provide an appropriate level of control without spending disproportionate amounts of money on an assurance regime.

### **The future of the performance measure**

**3.26** HMRC plans to gradually introduce a new basket of performance measures for the next spending review period. HMRC intends compliance yield to form part of this new performance management framework. The new measures will allow HMRC to give a more comprehensive picture of its overall performance by extending the scope of its measures beyond its traditional enforcement and compliance activities.

**3.27** HMRC will continue to use compliance yield as a performance measure in 2015-16. However, it will also trial the new performance measures alongside the compliance yield measure. This will enable it to review the data and, where necessary, continue to revise its performance measures so that it is in a good position to introduce them from 2016-17.

# Part Four

## Plans for tax administration

**4.1** In July 2014 HM Revenue & Customs (HMRC) announced its plans to undertake an ambitious programme of work to transform how it administers tax.<sup>16</sup> This will be HMRC's third major change programme since its formation in 2005.

**4.2** While HMRC's plans are in the early stages, it is already clear that the scale of the transformation is significant, and more complex and far-reaching than its previous change programmes. With such high levels of change we would expect any organisation to experience implementation difficulties and for some projects to fail. This part of the report:

- describes HMRC's history of delivering change;
- explains HMRC's new strategy to improve tax administration; and
- identifies high-level challenges HMRC faces in delivering its transformation plans.

**4.3** HMRC will develop detailed cost and delivery plans during the upcoming 2015 Spending Review. Therefore we have not evaluated HMRC's plans to deliver its strategy here. We intend to report on progress as the programme develops.

## Making changes

**4.4** HMRC has carried out two major change programmes since the merger of the Inland Revenue and HM Customs and Excise in 2005:

- **The Departmental Transformation Programme (2006-07 to 2010-11):** to deliver the service improvements, tax yield and efficiency savings from the merger.
- **The Change Programme (2011-12 to 2014-15):** to deliver commitments in the 2010 Spending Review settlement.<sup>17</sup> The programme's main aims were to reduce costs and increase tax revenues by reinvesting £917 million of efficiency savings into its compliance activities to generate additional revenues. It also included some transformation programmes like Real Time Information (RTI) for PAYE.

<sup>16</sup> Ruth Owen, 'Building our Future: transforming how HMRC serves the UK', speech to HM Revenue & Customs annual stakeholder conference, 17 July 2014. Available at: [www.gov.uk/government/speeches/building-our-future-transforming-how-hmrc-serves-the-uk](http://www.gov.uk/government/speeches/building-our-future-transforming-how-hmrc-serves-the-uk)

<sup>17</sup> Over the 4 years covered by the 2010 Spending Review (2011-12 to 2014-15), HM Revenue & Customs committed to reduce the administration budget by 33%; reduce spending by 25%; and generate additional revenue of £7 billion per year by 2014-15.

**4.5** HMRC has spent £4.6 billion on change programmes over the past nine years (£2.4 billion on the Departmental Transformation Programme and £2.2 billion on the Change Programme). The proportion of HMRC's total spending on change programmes has increased from 12% in 2011-12 to 20% (£682 million) in 2014-15 (**Figure 17**).<sup>18</sup>

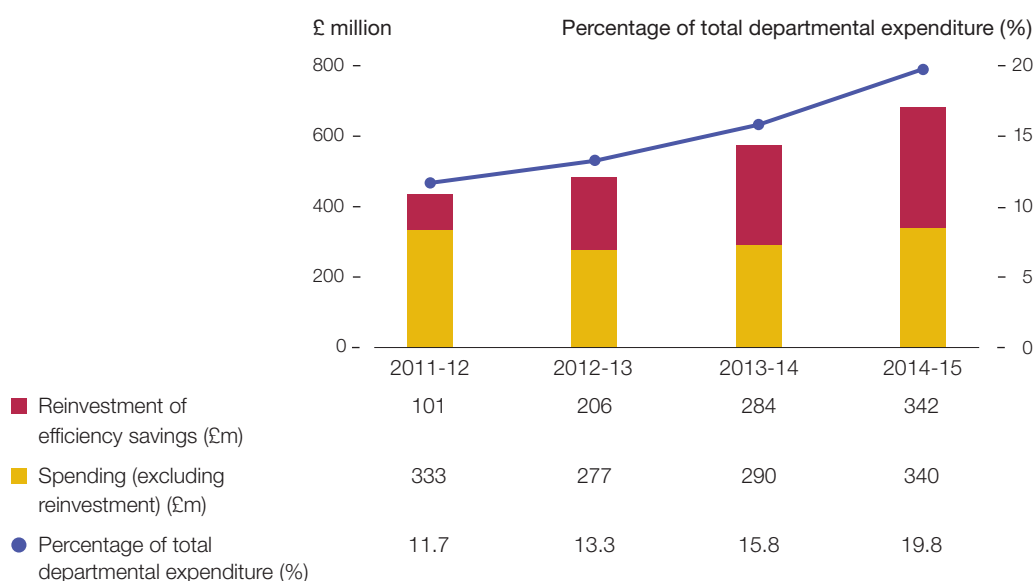
**4.6** HMRC designed its change programmes to maximise revenue, reduce running costs and improve the customer experience. Since its creation, HMRC has reduced the number of full-time equivalent staff by 40,000 (from 97,000 in April 2005 to 57,000 in March 2015) and the number of offices by more than two-thirds (from 593 to 190). It has reduced its annual running costs since 2005-06 by £0.7 billion, from £3.8 billion in 2005-06 to £3.1 billion in 2014-15.<sup>19</sup> At the same time it has increased the revenue it raises from compliance work.<sup>20</sup> It has modernised its services through initiatives such as:

- the expansion of online filing of tax returns since 2007;
- the integration of National Insurance and PAYE services in 2009;
- the introduction of an online VAT registration system in 2012; and
- the roll-out of RTI in 2013.

**Figure 17**

HMRC's annual expenditure on change programmes, 2011-12 to 2014-15

HMRC's total spending on change programmes has increased



**Note**

1 Total departmental expenditure includes both resource and capital spend.

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

<sup>18</sup> Total spending includes resource and capital departmental expenditure.

<sup>19</sup> HM Revenue & Customs' resource spending voted by Parliament (which excludes the costs of collecting National Insurance Fund income and the e-filing incentive payments) fell by £0.7 billion in cash terms between 2005-06 and 2014-15. After adjusting for inflation, the real terms decrease in HMRC's running costs over this period was 34% or £1.6 billion.

<sup>20</sup> HM Revenue & Customs, *Building our Future: Transforming the way HMRC serves the UK*, July 2014.

**4.7** HMRC estimates the financial benefits of its change programme using three primary measures. HMRC had targets for two of these measures in its 2010 Spending Review settlement: efficiency savings and compliance yield, both of which it met. HMRC later agreed to deliver a number of initiatives intended to deliver tax credits fraud and error savings: these are estimates of savings made by HMRC through the identification and resolution of fraud and error or through the increased success in collecting tax credit debt. By 2013-14 the Department estimated that it had reduced tax credits fraud and error to 4.4% against its target to reduce it towards 5.5% by 2014-15. This is discussed separately in Part Five of this report. In addition, HMRC also measures quantifiable customer benefits from its change projects, in the form of customer compliance cost reductions, but agreed no targets for this measure. HMRC estimates customer compliance cost reductions when it makes changes to services which reduce the cost to taxpayers of interacting with the tax system.

**4.8** When we reported on HMRC's progress on reducing its costs in 2013, we also looked at how well it managed change. We found HMRC managed change well, with robust reporting and monitoring arrangements in place. However, HMRC needed to do more to manage the dependencies and connections between projects and to better understand the link between the cost and value of activities.<sup>21</sup>

**4.9** HMRC has a strong track record in delivering IT-enabled change, and implementation problems have been the exception rather than the rule. However, making major changes to customer services often carries high risk and can have a big impact on taxpayers when things go wrong. For example, we have reported a number of times on HMRC's implementation of major projects to improve how personal tax is administered. We first reported on significant difficulties HMRC faced implementing a new service for National Insurance and PAYE (NPS) in 2009-10.<sup>22</sup> Millions of employees' tax records were affected, and it took HMRC a number of years to stabilise the new system. HMRC learned from its experience implementing NPS and its later major project to modernise PAYE between 2012 and 2014, known as Real Time Information, was more successful.

<sup>21</sup> Comptroller and Auditor General, *HM Revenue & Customs: Progress on reducing costs*, Session 2012-13, HC 889, National Audit Office, February 2013.

<sup>22</sup> Comptroller and Auditor General, *HM Revenue & Customs Annual Report and Accounts 2009-10*, Session 2009-10, HC 299, National Audit Office, July 2010.

## Improving tax administration

**4.10** HMRC launched its new strategy for transforming the tax system in June 2014.<sup>23</sup> The strategy aims to help customers pay the right amount of tax at the right time by making better use of its data and providing more personalised online services. A key ambition is to give every customer in the UK a personal online tax account so that they can manage all their tax affairs easily in one place, rather than deal with HMRC separately for each tax they pay. The March 2015 Budget announced the end of the annual tax return by the end of the next Parliament.<sup>24</sup>

**4.11** HMRC's strategy will affect almost all customers in some way during the next Parliament. Examples of the impact of the changes on customer experience are:

- **Improving the provision of systems, guidance, and support to make it easier to comply:** Customers accessing their online tax accounts will get intelligence-led guidance and automated answers to their queries. This will help them carry out more tasks themselves. Face-to-face and phone support will be available for those customers who need extra help.
- **Automating routine processing of tax information and transactions:** Moving services online means that many manual processes will become automated. For example, HMRC plans to pre-populate tax returns and online accounts with real-time data. This will save customers' time and reduce the need for contact and manual processing by HMRC.
- **Concentrating resources on enforcement and compliance activities to tackle tax avoidance and evasion:** HMRC expects compliance staff will need less time on routine work and correcting errors. Compliance staff will have better data and information about risks to tax revenue. This means they can focus more on dealing with taxpayers who deliberately avoid or evade their taxes.

<sup>23</sup> See footnote 16.

<sup>24</sup> HM Revenue & Customs, *Making tax easier: The end of the tax return*, March 2015.

**4.12** To deliver its strategy, HMRC has started re-designing its processes and services around customers, rather than around the taxes they pay. HMRC expects to:

- **develop a ‘multi-channel digital platform’** that interacts with customers flexibly through a range of channels such as web chat and secure messaging;
- **create a ‘single customer view’ in HMRC** that allows staff to see information about all the taxes paid by an individual, and their interactions with HMRC, in one place;
- **give small and medium enterprises (SMEs) ‘your tax account’** – an online service with a personalised homepage, providing an overview of the SME’s main taxes and allowing it to quickly access all services from one place; and
- **build an ‘enterprise data hub’ to house all HMRC data**, replacing its current system of multiple, disconnected data stores to allow HMRC to analyse data more easily and efficiently, and to improve customer service and compliance.

**4.13** HMRC’s strategy means changing the shape and size of its workforce and estate to support the new way of administering tax. HMRC intends to reduce spending on its buildings. It will use resources more flexibly by consolidating its 190 existing offices into a small number of large regional centres. HMRC expects to continue reducing its staff. It plans to invest in developing new skills in its staff, recognising that its needs will change. For example, compliance staff will increasingly focus on complex and challenging cases. This will require new legal and analytical skills. HMRC also intends to invest in developing its digital, programme and project management, and commercial skills.<sup>25</sup>

## **Key challenges to making changes**

**4.14** HMRC is beginning to plan activities to deliver its strategy over the next five years. It expects to spend over £500 million on the changes during 2015-16 (around 15% of its total spending). It will decide how to fund and schedule key activities after 2015-16 during the upcoming Spending Review; HMRC and HM Treasury will also agree new performance measures to monitor progress and hold HMRC to account for its performance.

**4.15** HMRC must change more radically than it has in the past to achieve this transformation. HMRC’s previous change programmes had focused on increasing efficiencies, improving processes and investing more in pre-existing compliance activities. This time the change programme is more ambitious and more complex: making planned cost reductions while moving millions of taxpayers to digital customer services and decommissioning old ones.

<sup>25</sup> See footnote 20.

**4.16** We reviewed HMRC's strategy and identified three high-level challenges it will face delivering its transformation plans:

- **Managing the high levels of complexity and ambition in HMRC's plans, given the scale of the transformation that will be required, alongside further cost reductions.**

In 2013 we reported on HMRC's progress in reducing its costs. We found it had more to do to understand how all its change projects linked together and to identify the key projects that will enable it to reduce costs.<sup>26</sup> HMRC's new change programme is more complex than the one we reviewed in 2013: it has more than double the number of projects. These projects will be delivered across all parts of HMRC's business, often by new cross-organisational teams. Establishing the right sequencing, managing dependencies and prioritising the most valuable projects will be challenging. HMRC will also need the commitment and resilience not to be deflected from the delivery of its strategic vision when implementation problems occur.

While HMRC has a generally successful record in delivering change, it recognises its transformation plans are more ambitious than its earlier change programmes. It will need to balance this ambition with realism about its critical assumptions and make contingency plans. Other departments face similar issues: our work on implementing welfare reforms found that the Department for Work & Pensions had relied too much on assumptions that were uncertain and unchallenged. It did not have a sufficient understanding of its portfolio of programmes or overall capacity to manage them.<sup>27</sup>

- **Managing significant operational change alongside changes to how it procures and manages its digital services.**

Digital technology is one of the primary enablers of HMRC's planned transformation by 2020. For the past 11 years HMRC has procured the majority of its IT (including digital) services through the Aspire contract. The Aspire contract ends in 2017. HMRC will therefore need to implement its digital transformation alongside activity to replace the Aspire contract.<sup>28</sup>

<sup>26</sup> See footnote 21.

<sup>27</sup> Comptroller and Auditor General, *Department for Work & Pensions: Welfare Reform – lessons learned*, Session 2015-16, HC 77, National Audit Office, May 2015.

<sup>28</sup> Comptroller and Auditor General, *HM Revenue & Customs: Managing and replacing the Aspire contract*, Session 2014-15, HC 444, National Audit Office, July 2014; Comptroller and Auditor General, *The HMRC VAT Service: the impact of legacy ICT*, August 2013.

- **Designing management information into programmes from the start.**

HMRC will need to decide how to measure and record the benefits expected from its transformation. HMRC's current customer service measures include the speed of its response to telephone queries. If HMRC is successful in helping customers to get their tax returns right first time, this should reduce demand for telephone contact. A key challenge will be for HMRC to establish what its current services cost, and develop how it measures the impact of any changes on its customers. This includes developing leading indicators for major risks within programmes. HMRC recognises that it will need to change the measures it uses to prioritise investments, measure progress and evaluate whether its transformed services are more cost-effective. It is developing a new set of performance measures for 2016.

**4.17** We intend to return to HMRC's transformation over the coming five years as it develops more detailed and specific plans. We will review how well HMRC manages these challenges.



## Part Five

### Personal tax credits

**5.1** HM Revenue & Customs (HMRC) paid £29.1 billion in tax credits in 2014-15. This supported around 4.6 million families and around 7.6 million children. Tax credits represent 57% of the Department's total expenditure of £51 billion recorded in the HMRC Resource Accounts.

**5.2** Tax credits were introduced in April 2003, with the aim of providing support to families with children; tackling child poverty; and helping to make sure that work pays more than welfare. The government is continuing the roll-out of Universal Credit which will replace many of the current working-age benefits, including tax credits, with a single means-tested payment. HMRC will retain responsibility for administering the tax credits scheme until all existing claimants have migrated to Universal Credit, which is currently expected to be in 2021. Tax credits are complex:

- **Over- and under-payments are inherent in the system.** Tax credits are awarded on an annual basis. HMRC makes a provisional award based on the information it holds. It makes in-year payments based on estimated figures and then calculates the final amount after the end of the year, once actual household income and circumstances are known. At finalisation of awards, HMRC can identify under- and over-payments. It then makes any necessary adjustments and, as needed, undertakes recovery action.
- **Tax credits entitlement is based on a range of eligibility criteria.** Criteria include hours worked; number of children; disability; childcare costs; household income; and household composition. It is difficult to maintain accurate information on claimants' circumstances for some of these criteria, particularly household composition and hours worked.
- **Tax credits are designed to respond to changes in household income.** The value of tax credits is reduced when household income reaches certain thresholds. Household income is less easy to measure than personal income.
- **HMRC depends on claimants notifying it of changes in their circumstances.** Claimants are responsible for providing accurate details of their circumstances and notifying HMRC if any changes occur. This includes providing information at the year end to confirm actual circumstances. Claimants do not always fully understand what they need to report, leading to inaccurate or non-reporting of changes to their circumstances.

**5.3** The complexities in tax credits present challenges for HMRC in administering awards and for claimants in meeting their obligations. Where HMRC finds a claimant who has been paid more than they are entitled to, it seeks to recover the overpayment. At 31 March 2015 the total value of tax credits debt and overpayments still to be recovered from claimants was £6.9 billion.

**5.4** This part covers:

- the estimated level of fraud and error in tax credits;
- why the Comptroller and Auditor General (C&AG) qualified his audit opinion in 2014-15;
- HMRC's progress in reducing tax credits fraud and error;
- HMRC's progress in managing tax credits debt recovery; and
- future challenges.

### Estimated level of fraud and error in tax credits

**5.5** HMRC estimated that the overall level of fraud and error in 2013-14 decreased to 4.4% of expenditure (from the revised figure of 5.3% in 2012-13) (**Figure 18**). This equates to overpayments of £1.26 billion and underpayments of £0.18 billion.

**Figure 18**

HMRC's estimate of fraud and error in 2013-14

	2013-14		2012-13	
	(£bn)	(%)	(£bn)	(%)
Total expenditure	29.3	–	29.7	–
Estimated overpayments due to fraud and error				
Central estimate	1.26	4.4	1.52	5.3
Range	1.12–1.41	3.9–4.9	1.33–1.72	4.7–6.0
Estimated underpayments due to error				
Central estimate	0.18	0.6	0.13	0.5
Range	0.15–0.22	0.5–0.8	0.06–0.20	0.2–0.7

**Note**

1 HMRC revised the 2012-13 estimate in June 2015. The table includes the revised figures. The central estimate of overpayments changed from £2.01 billion representing 7% of entitlement. Underpayments changed from £0.20 billion representing 0.7% of entitlement.

Source: HM Revenue & Customs, *Child and Working Tax Credits Error and Fraud Statistics, 2012-13 and 2013-14*

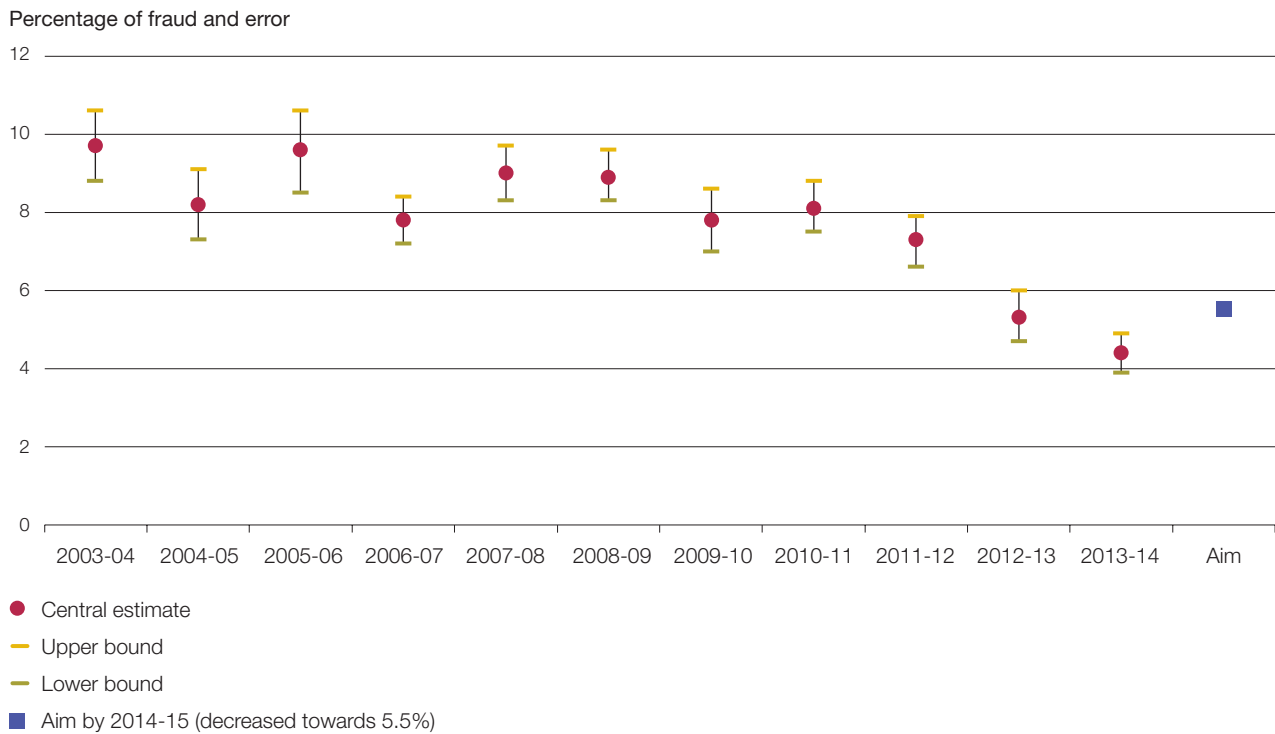
**5.6** HMRC estimates that it has reduced fraud and error overpayments from 8.1% in 2010-11 to 4.4% in 2013-14, which is the lowest level since tax credits were introduced (**Figure 19**). In June 2015 HMRC released its estimates for 2013-14 and revised the 2012-13 estimates from 7.0% to 5.3%, a reduction of £490 million. HMRC has not yet had time to assess reasons for reductions more fully and is planning to conduct further detailed analysis. Based on its initial examination:

- HMRC believes that the increasing number of compliance checks over this period, particularly in its work with credit reference agencies to tackle the undeclared partner risk, have helped to reduce fraud and error. It plans to do more analysis to better understand the link between initiatives and outcomes.
- HMRC's assessment is that around half of its revision of 2012-13 estimates was due to the previous over-statement of losses for the undeclared partner risk. This was caused by awards, sampled in the exercise to produce the estimates, that HMRC initially assessed as incorrect that were overturned or amended on appeal. In some cases, the result of the appeal was not known at the time of the initial measurement period. In other cases, HMRC found it had misclassified some awards as fraud and error when compiling the original estimates.
- HMRC understands the reasons for the revision of losses for the income risk which was partly caused by its misclassification of losses between years. It has not established a full understanding of the reasons for the remainder of the revision by risk type, including a £90 million reduction in losses due to work and hours.

**5.7** In 2013 HMRC set an aim to reduce losses through fraud and error towards 5.5% of tax credits entitlement by the end of 2014-15. HMRC has already reduced losses below this level and needs to sustain and improve on this in future. Due to the lag in measuring of fraud and error, the final results for 2014-15 will be available in June 2016.

**Figure 19**

HMRC's fraud and error estimates from 2003-04 to 2013-14, including projections to 2014-15 'towards 5.5%' aim

**Note**

1 HMRC reports fraud and error within a range around a central estimate. The figures referred to within this report are the central estimates. The methodology meets the national standard for official statistics. It is HMRC's best estimate of fraud and error.

Source: HM Revenue & Customs, *Child and Working Tax Credits Error and Fraud Statistics, 2003-04 to 2013-14*

## The C&AG's audit opinion

**5.8** 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 sufficient evidence 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).

**5.9** The C&AG has qualified his regularity opinion on HMRC's 2014-15 Resource Accounts because of the material level of fraud and error in tax credits expenditure. This expenditure has not been spent as Parliament intended and does not conform to the requirements of the Tax Credits Act 2002 (the Act). The Act specifies the criteria that govern entitlement to tax credits and the method that HMRC should use to calculate the amounts to be paid. Transactions do not conform to the governing legislation and are therefore irregular for one of two reasons:

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

**5.10** This is the fourth consecutive year in which HMRC's Resource Accounts have been qualified for irregular tax credits expenditure. Between 2003-04 when the scheme started and 2010-11, tax credits were reported in HMRC's Trust Statement. This account was qualified for each of these years. As a result, the C&AG has reported to Parliament on tax credits every year since they were introduced.

**5.11** Note 6.3 to HMRC's Resource Accounts discloses its best estimate of all fraud and error within the tax credits system.

## **HMRC's work to reduce fraud and error**

**5.12** HMRC has previously sought to reduce fraud and error by increasing the volume of interventions and targeting major risk areas. In 2013, our Tax Credits report acknowledged that HMRC had taken an innovative approach and significantly increased the number of interventions.<sup>29</sup> HMRC's focus has evolved as it has sought to make its compliance activities more effective and develop a broader approach to stopping overpayments from occurring. It has focused on:

- improving the effectiveness of its compliance activity;
- extending its capacity to tackle overpayments;
- making changes to scheme rules and requirements; and
- improving its support to claimants.

### **Improving the effectiveness of compliance activity**

**5.13** HMRC seeks to target its resources at claims that pose the highest risk of financial loss. Its work is directed by risk area and different stages of the tax credits system (that is, new awards, change of circumstance, renewal and finalisation of claim). HMRC is refining its data analysis and predictive analytics techniques to identify the riskiest claims.

29 Comptroller and Auditor General, *HM Revenue & Customs: Tackling tax credits error and fraud*, Session 2012-13, HC 891, National Audit Office, February 2013.

**5.14** HMRC is continuing to seek access to new data sources to establish better information to support decisions on eligibility and entitlement. It has identified a number of potential data sources such as data to help them identify school leavers and the existence of children. HMRC has been working on a number of proposals but has faced difficulties in securing access to additional data in the form that it requires for large scale analysis. There is also scope to make more use of its own data from tax evasion work, such as its taskforces and work to identify customers who may avoid paying taxes as part of the 'cash economy'.

### Extending capacity

**5.15** HMRC has recognised that, despite its increase in compliance activity, a significant number of claims are still incorrect, leaving undetected fraud and error in the tax credits system. In our 2013 report we recommended that HMRC use third parties to increase the number and quality of its interventions.

**5.16** In May 2014 HMRC signed a contract with Synnex-Concentrix UK Ltd to provide additional capacity to tackle fraud and error on a payments-by-results basis. The aim was to increase the number of compliance interventions. So far, the benefits of the contract have been lower than anticipated. This is because of delays in the service going live and a lower than expected number of interventions completed by the supplier. HMRC estimates that the project delivered savings of £0.5 million in 2014-15, compared with its original forecast of £285 million. The original estimate of £1 billion savings over the three year contract is not achievable. HMRC currently estimates that the project will deliver savings of £423 million, although this relies on increasing staff numbers and improving performance.

### Making changes to scheme rules and requirements

**5.17** HMRC has made policy changes to tackle fraud and error risks. The changes introduce obligations for claimants to provide additional information to support their claim, providing HMRC with better information to make decisions on entitlement. For example, the 2014 Autumn Statement, included measures to investigate where it believes there is a risk of fraud by a self-employed individual. Other measures announced in previous Autumn Statements required claimants to provide:

- regular updates from households reporting high childcare costs; and
- evidence on a child's education status each year for all children aged between 16 and 19.

HMRC estimated in March 2015 that these changes would save up to £471 million over the next five years.

## Improving support to claimants

**5.18** HMRC has updated the interactive guidance for its contact centre staff to lead claimants through tailored questions to prevent errors that cause overpayments. HMRC's long-term vision is to introduce digital accounts to verify customer information and prompt claimants to keep this up-to-date.

## Fraud and error by risk area

**5.19** HMRC analyses the level of fraud and error against 6 main causes of loss. We use these data to help review performance, focusing on trends in reducing losses. **Figure 20** shows that HMRC has made sustained reductions in most risk areas since 2010-11 and has maintained losses at a relatively low level for the disability risk. HMRC has not reduced losses due to claimants misstating their income, although this will be affected by changes to the income disregard.<sup>30</sup> The losses due to undeclared partner and 'work and hours' have fallen considerably in 2013-14 (and in the revised 2012-13 estimates). HMRC will analyse the results of its annual exercise in greater detail to improve its understanding of the causes of fraud and error.

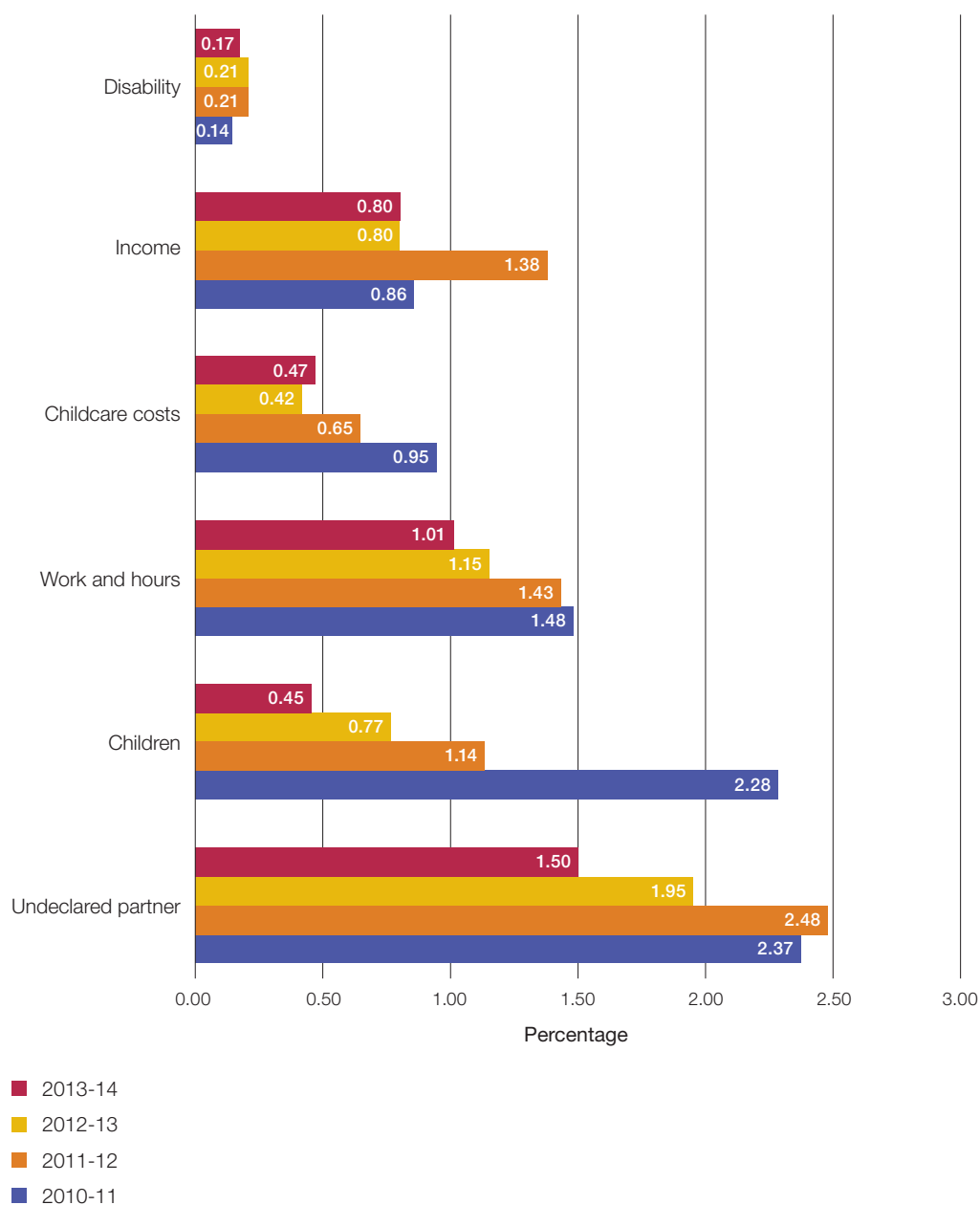
**5.20** We have used this breakdown to assess how the Department's fraud and error activities address risks. **Figure 21** on page R64 summarises the main changes that HMRC has recently introduced. HMRC has a range of activities across the major risk areas to prevent and detect fraud and error, although the impact of some changes will not yet be reflected in the most recent fraud and error estimates. Despite recent progress, HMRC still needs to develop more effective approaches to reducing losses for undeclared partners and work and hours risk types. These risks account for £720 million of fraud and error and HMRC needs to assess the extent to which it is able to further reduce losses. For example, HMRC could better understand claimant behaviours and the reasons why they do not provide the correct information.

**5.21** Figure 21 sets out some of the work HMRC is currently undertaking by risk area. This work is part of a suite of approximately 60 activities it carried out during 2014-15. HMRC estimates that it prevented £469 million of fraud and error that may otherwise have gone undetected. The activities are aimed at individual risk types as well as multiple risks and seek to identify misreported circumstances as well as unreported changes of circumstances.

<sup>30</sup> The income disregard is the amount HMRC allows a customer's income to move by, before it affects the value of their award. Hence, not all income changes reported by the customer result in an adjustment to their payments. The value of this disregard decreased in April 2013 to £5,000 from £10,000.

**Figure 20**

HMRC's fraud and error estimates by risk area for 2010-11 to 2013-14

**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.

Source: National Audit Office analysis of HM Revenue & Customs' *Child and Working Tax Credits: Error and Fraud Statistics 2010-11 to 2013-14*



**Figure 21**

## HMRC's main fraud and error interventions by risk type

Risk area	Estimated loss 2013-14		HMRC's interventions by risk type
	(£m)	(%)	
Undeclared partner	430	34	HMRC works with a credit reference agency to identify whether a single claimant has financial connections with another adult. It is also exploiting other data it holds (from Real Time Information (RTI) and Connect) and using information from the Department for Work & Pensions (DWP).
Work and hours	290	23	<p>HMRC initially hoped to use data from employers submitted through RTI, but has been unable to use this source due to limitations in the data.</p> <p>The Autumn Statement 2014 included measures requiring self-employed individuals to pass a 'genuine and effective work test' and register for self-assessment. HMRC believes this may help address this risk, but the change only came into effect in April 2015.</p>
Income	230	18	HMRC is using RTI on customers' income to identify errors due to undeclared or understated income. This was used as part of their finalisation of 2013-14 awards and throughout the year.
Childcare costs	135	11	<p>The Autumn Statement 2012 announced a change to policy requiring regular updates from households reporting high childcare costs.</p> <p>HMRC's interactive guidance for contact centre staff is designed to help claimants calculate their childcare costs. However, contact centres are managed under a separate directorate and this guidance is not always used.</p>
Children	130	10	<p>HMRC requires claimants to provide a declaration on education status of children aged between 16 and 19. It also sends letters to parents of 18-year-olds asking whether they remained in full-time education, amending the award if they fail to comply.</p> <p>HMRC also identifies discrepancies between claimants tax credits and child benefit data.</p>
Disability	50	4	HMRC uses DWP data to identify customers incorrectly claiming the disability element of tax credits.

Source: National Audit Office analysis

**HMRC's management of tax credits overpayments**

**5.22** Tax credits overpayments arise when a claimant is paid more than they are entitled to receive. HMRC seeks to recover overpayments that are identified. The tax credits debt balance rose in 2014-15 to £6.9 billion (£6.5 billion at 31 March 2014).<sup>31</sup> A proportion of this balance relates to finalisation, an estimate included for the first time in 2013-14, which recognises an estimate of overpayment debt a year earlier than previously. Without finalisation the balance would be £6.1 billion (£5.5 billion 2013-14). HMRC's original target was to reduce the gross tax credits debt balance to £3.7 billion by March 2015.

<sup>31</sup> Overpayments are reported as debt owed to HMRC in the HMRC Resource Accounts within the tax credits receivables note 6.2. The figures include an accounting estimate for overpayments created in the renewals period after year end (finalisation) that relate to the year of the accounts. Operationally, HMRC does not refer to the total balance as debt, classifying debt only as those overpayments being recovered through direct engagement with the customer. Overpayments being recovered via deductions from existing awards are not included in its classification.

**5.23** HMRC considered a target on the tax credits debt balance was not the most appropriate performance measure. Tax credit debt levels are likely to increase as improvements in detecting fraud and error increase the amount of identified debt. HMRC therefore introduced a new target that emphasises cash recovery. In 2014-15 HMRC had a recovery target of £970 million. It achieved recoveries of £967 million (2012-13, £815 million).<sup>32</sup>

## Progress in improving debt collection

**5.24** In the 2013 Autumn Statement, the government announced that HMRC would expand its capacity to recover tax credits debts by making increased use of private sector debt collection agencies. Since August 2014 HMRC has sent cases to a private sector company, TDX. The company has collected £15.5 million so far on behalf of HMRC and estimates it will recover a further £37.4 million from payment plans set up with customers. In total HMRC estimates £97 million recoveries were put in place in 2014-15 because of this measure.<sup>33</sup> The use of a third party to collect debts allows HMRC to redeploy staff to collect other debts with higher recovery rates. As a result, HMRC bases the benefit of this measure on the recoveries collected through the contract plus recoveries collected by redeployed staff.

**5.25** In the 2012 Autumn Statement HMRC announced a project to recover £520 million of historical tax credits debt (revised in 2013-14 to £480 million). The project started six months later than planned in October 2014. It involved HMRC updating its IT systems to collect this debt. HMRC can now deduct a proportion of the payment from a claimant's new award when it identifies that the same person already has a debt on a previous award. HMRC did not achieve forecasted benefits for the first year of this project. In the light of this experience, it reduced its estimate of planned recoveries to £413 million.

## Future challenges for HMRC benefits and credits

### Universal Credit

**5.26** Under current plans Universal Credit will replace tax credits. In September 2014, DWP extended the timetable for transferring tax credit claimants to Universal Credit. New tax credits claims will gradually stop and, on current plans, there will be no new claims for tax credits after December 2017. HMRC will be responsible for administering the tax credits scheme until claims are closed and existing customers are migrated to Universal Credit. HMRC currently expects to maintain a tax credits caseload until 2021.

<sup>32</sup> The figures quoted here for recovery do not align directly with the figures disclosed in Note 6.2 of the 2014-15 Resource Accounts. The recovery target captures only cash collected and the value of 'time to pay' arrangements. The Resource Accounts figures also include other adjustments to the receivables balance.

<sup>33</sup> This balance is made up of actual cash recoveries and direct debit arrangements set up (as at 27 March 2015). Actual recoveries may be lower if obligations under direct debit arrangements are not fully met.

**5.27** HMRC's plans are based on DWP's approved migration timetable. As at March 2015, HMRC had stopped 7,000 claims (0.2% of claimants) as customers started to claim Universal Credit. The fall in the number of tax credits cases is based on claimants becoming eligible for Universal Credit following a change in their circumstances. Tax credits claims will start to fall significantly from May 2016 as claims are closed on a geographical basis. Under current forecasts HMRC still expects to be administering 660,000 tax credit claimants in December 2019.

**5.28** HMRC will monitor the risks created by the migration while it continues existing fraud and error activities. It will consider the investment required to maintain and improve systems, given the extra time it will need to administer tax credits.

**5.29** HMRC is working closely with DWP to agree arrangements for the recovery of Tax Credit debt once customers move into Universal Credit.

## Digital

**5.30** In 2014-15 HMRC considered further how to extend its use of digital services to interact more widely with claimants. It intends to build upon its digital renewals system introduced at the beginning of 2014-15 to allow customers to report changes of circumstances online throughout the year. This would reduce overpayments that build up when customers wait to report changes of circumstance until they renew their claim following the year end. HMRC needs to continue monitoring how the behaviour of its digital customers differs from their traditional customers, and whether it needs to adapt its response to prevent and detect fraud and error.

## Child Benefit

**5.31** Child Benefit expenditure will take on more prominence in the Resource Accounts as tax credits payments start to decrease with the roll-out of Universal Credit. Levels of fraud and error in Child Benefit are lower than in tax credits. This is attributed to the relative simplicity of the eligibility criteria. However, administering the benefit has become more complex with the introduction of the High Income Child Benefit Charge.<sup>34</sup>

**5.32** HMRC currently estimates the level of overpayments due to fraud and error as £175 million. It is now improving the robustness of its estimate of fraud and error. We will monitor HMRC's performance in tackling fraud and error, using the new methodology to track progress.

**5.33** HMRC can draw on its experience of tackling tax credits fraud and error to refine its approach to Child Benefit compliance work, and it could build on existing analytical techniques and methodologies to identify the underlying causes and entry points of fraud and error. This would help it to better target its controls and interventions within Child Benefit.

<sup>34</sup> From January 2013 a tax charge was introduced for those in receipt of child benefit if they or their partner have an individual income over £50,000.

# Appendix One

## Our evidence base

- 1 We reached our conclusions on HMRC using evidence collected between September 2014 and June 2015.
- 2 As part of our financial audit, we reviewed the supporting information for HMRC's Trust Statement and Resource Accounts and their disclosures. We analysed and discussed with officials the supporting data prepared by a variety of business units in HMRC.
- 3 As part of our Section 2 audit on the adequacy and integrity of HMRC's revenue collection systems, we reviewed the systems for revenue collection across all different tax streams, as well as HMRC's debt management system, and the Real Time Information system introduced for PAYE.
- 4 Our analytical review in Part One was based on an analysis of the numbers published in the financial statements, plus an analysis of supporting information provided during the course of the financial audit.
- 5 Our review in Part Two of HMRC's assessment of the tax gap and tax risk looked at external reviews of HMRC's tax gap methodology. We reviewed the methodology and analysis used for HMRC's 'Strategic Picture of Risk' and considered how this drives action. We also considered the NAO's recent findings on HMRC's response to tax risks.
- 6 As part of our review of how HMRC measures compliance yield in Part Three, we reviewed HMRC's progress on implementing the recommendations made by the Committee of Public Accounts. Our findings are based on testing of the controls around the scoring and reporting of compliance yield, document review, interviews, site visits to various lines of business across the three main directorates of HMRC, and reviews of 81 case files including Local Compliance, Large Business and Specialist Personal Tax cases. We also assessed the robustness of HMRC's method of estimating its yield by considering whether the measure:
  - is based on the best evidence available;
  - is reported in a transparent way;
  - allows comparison of HMRC's performance over time; and
  - is subject to robust processes to assure data quality.

**7** To provide the evidence for Part Four's consideration of HMRC's plans for tax administration, we reviewed the strategy, governance and risk management for HMRC's portfolio of projects in its current change programme. We conducted interviews with key members of staff involved in planning the transformation, and reviewed documents prepared by HMRC as it developed its new strategy.

**8** In addition to our standard financial audit work around personal tax credits, for Part Five we also reviewed HMRC's error and fraud statistics analysis, and information on the performance of initiatives to reduce error and fraud in tax credit payments. We also interviewed key staff and reviewed documents on HMRC plans and strategies around tax credit debt, and reviewed the performance of strategic initiatives such as the use of debt collection agencies.

**9** In addition, we also reviewed:

- HMRC's internal audit reports to understand their management of risks and challenges.
- HMRC's corporate publications on measuring the tax gap and on compliance performance.

**10** We reviewed relevant NAO and Committee of Public Accounts reports on HMRC's performance in the past year, including reports on tax reliefs, and its management of the Aspire contract, as well as HMRC's responses to recommendations on taxation from the Committee of Public Accounts since 2010.

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