Presented pursuant to the Government Resources & Accounts Act 2000 c20 s6
and the Exchequer & Audit Departments Act 1921 c52 s2

HM Revenue & Customs 2006–07 Accounts

– Consolidated Resource Accounts
– Trust Statement
– Standard Report

(For the year ended 31 March 2007)

Ordered by the House of Commons
to be printed 12 July 2007

LONDON: The Stationery Office 12 July 2007

HC626 £22.50

HM Revenue & Customs 2006–07 Accounts

Contents	Page

Statement on Internal Control

1. Scope of responsibility

1.1 As Principal Accounting Officer, I have responsibility for maintaining a sound system of internal control that supports the achievement of HM Revenue & Customs (HMRC) policies, aims and objectives, whilst safeguarding the public funds and Departmental assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Government Accounting.

1.2 As Executive Chairman of HMRC I am accountable to the Chancellor, and to the Paymaster General, to whom the Chancellor has delegated responsibility for the day to day oversight of the Department. The Paymaster General is kept informed of progress and significant issues facing the Department in the course of regular bilateral meetings that she has with me and the other Board members.

1.3 As Principal Accounting Officer for HMRC I am supported by a number of Additional Accounting Officers. Each of these has clearly defined responsibilities outlined in their appointment letters. Their relationship with me is also clearly set out in separate Memoranda of Understanding.

1.4 The Valuation Office Agency (VOA) is an Executive Agency of HMRC. The Chief Executive of the VOA is an Additional Accounting Officer for the resources authorised by Parliament in relation to the VOA. The relationship between the VOA and HMRC is set out in the VOA's Framework Document, and in a separate Memorandum of Understanding between the VOA's Chief Executive and myself.

2. The purpose of the system of internal control

2.1 The system of internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to: identify and prioritise the risks to the achievement of Departmental policies, aims and objectives; to evaluate the likelihood of those risks being realised and the impact should they be realised; and to manage them efficiently, effectively and economically. The system of internal control has been in place in HMRC for the year ended 31 March 2007 and up to the date of approval of the accounts, and accords with HM Treasury guidance.

3. Governance

3.1 A detailed description of HMRC's high-level governance, including its senior committee and business structure, can be found in the Corporate Governance Report, published as a separate section to the Accounts.

4. Risk Management

4.1 The risk management arrangements in the Department have been working effectively throughout the year, but we continue to review and adapt them to ensure they remain fit for purpose.

Capacity to handle risk

4.2 The Executive Committee takes an active role in shaping the Department's approach to risk, determining the risk priorities, and reviewing progress in managing the risks in the Departmental Risk Register. They are supported in this by the Risk Management Group. This is a peer-review group of risk owners, who challenge the effectiveness of action to manage our top risks, and identify new emerging risks. The Executive Committee, along with some Directors, held a workshop in October 2006 to explore options for improving risk management.

4.3 The Audit Committee, supported by Internal Audit and informed by the work of National Audit Office (NAO), provides me with independent advice on the effectiveness of the Department's governance, risk and control arrangements.

4.4 There are a number of strands of activity aimed at ensuring staff throughout the Department are aware of risk management principles and how to apply them:

- Risk management is increasingly being integrated into planning and performance.
- Risk management guidance on the intranet has been refreshed.
- The Governance & Risk Network helps ensure a shared understanding across the Department of risk management, and identify and share examples of good practice.

The risk and control framework

4.5 The approach to risk management in HMRC involves the upward reporting of risks. The primary mechanism for this is the Directors' monthly and quarterly performance reports. These Director-level risks inform the strategic risk management process, which is focused around the Departmental Risk Register. Ownership of the risks in the Departmental Risk Register is assigned at Executive Committee level, and at the next level of management down – the Delivery Manager.

5. Control

Departmental Transformation Programme

5.1 The five-year Departmental Transformation Programme (DTP) is an ambitious programme of service transformation aimed at maximising efficiency and effectiveness by putting the customer at the heart of everything we do. It is probably the largest programme of change in the UK at present impacting, as it does, on every member of staff and every individual and business in this country. It involves many overlapping projects and programmes and poses a massive and complex challenge to track progress, understand associated risk and integrate all of this into a co-ordinated effort that ultimately delivers results. Risks that cannot be managed at individual project or programme level or which could have an impact on DTP as a whole will be escalated to a DTP Programme Office (DTPO) who will identify, manage and review cross-cutting risks and issues within the Programme Portfolio, reporting as necessary to a Programme Board and to Ministers. Responsibility for managing the DTP change control process and tracking cross-programme dependencies will also reside with the DTPO.

Government Banking Programme

5.2 The Government Banking Programme (GBP) was set up in 2006 to deliver the future clearing banking needs of HMRC, the Office of HM Paymaster General (OPG) and National Savings & Investments (NS&I) through a single shared service provider. The provider, which will be part of HMRC, is called the Government Banking Service. GBP involves procuring banking and transaction processing services from commercial suppliers to replace the Bank of England as a major supplier of bulk clearing banking services to Government.

5.3 The scale of the combined banking operation is very large. In addition to the throughput of HMRC and NS&I, OPG, which has a customer base of over 900 public sector bodies, including Departments, Agencies and NHS bodies, processed approximately £1,800 billion worth of payments in 2005-06. As a consequence of the transfer of functions HMRC now carries a significant risk related to service delivery. The Programme Board has adopted a robust approach to the identification and reporting of risks and potential issues and will continue to review this throughout the life of the programme.

Tobacco Strategy

5.4 The smuggled tobacco market has undergone considerable change since the Tackling Tobacco Smuggling Strategy was launched by HM Customs and Excise in 2000. In particular the cross-channel smuggling of cigarettes from the near continent has drastically reduced and large scale freight smuggling has switched from mainly UK manufactured product to mainly counterfeit product. We have also seen the quality of counterfeit product rise and its cost fall over this period. Driving the illicit market lower by reducing profitability of smuggling in a situation in which supply costs are falling has therefore become progressively harder. Moreover, smoking is in long term decline. The total consumption of cigarettes has fallen from around 76.5 billion sticks in 2000-01 to 68 billion in 2004-05. Consequently any given volume of smuggled product will over time represent a progressively larger percentage share of the total market.

5.5 In response to this changing picture, the Government published 'New Responses to New Challenges' in the 2006 Budget. This contains four key measures designed to robustly tackle tobacco smuggling. These measures included working closely with tobacco manufacturers to improve the targeting of counterfeit product through Memoranda of Understanding; re-focusing HMRC's operational response and in particular strengthening enforcement activity along the supply chain; utilising available technology to detect goods; and maximising publicity and communication to increase the awareness of HMRC enforcement action. These measures have now been implemented across the Department. We are constantly looking for new solutions which will help drive down the illicit market. For example, in the Budget 2007 the Government announced a voluntary agreement with UK tobacco manufacturers to introduce covert markings on tobacco products to help tackle the problem of counterfeit tobacco.

5.6 In 2006-07 the resource levels the Department was able to deploy to combat tobacco smuggling were impacted by the need to respond to the escalating threat of VAT missing trader fraud (see paragraph 6.18). Steps have been taken to supplement resource levels for 2007-08 but this may take time to feed through into results. There are also difficulties in providing an absolute measurement of success against the target due to a lack of precision in the Office of National Statistics data on total cigarette consumption. We have calculated that the illicit market in 2004-05 was in the range of 10-19 per cent. There is a significant risk that the top of this range will not be below the Public Service Agreement target of 13 per cent by the end of 2007-08. It is, however, equally likely that the bottom of the range will be below 13 per cent and we remain optimistic that our enhanced operational effort will deliver an illicit market share of around the 13 per cent target evidenced by data from a variety of indicators.

Other Developments

5.7 The work performed by Directors during the year on governance, risk and control is also reflected in a number of notable developments including:

- Further developments in the governance of tax credits. A Tax Credit Management Board (TCMB) now meets monthly and focuses on the strategic management of tax credits. This has replaced the strategic group and will increase the focus on the strategic management of tax credits. It has ownership of key operational targets and performance indicators for the tax credits process. It acts as a stakeholder reference group for the transformation programme and receives regular reports from the programme director. The chair of the Tax Credits Operations Group (TCOG) is a member of the TCMB thereby ensuring clear line of sight and early identification of significant day to day operational issues.
- A Compliance Strategy Group made up of Executive Committee members and Directors with an interest in compliance. This looks at future compliance issues, risks and opportunities and works out how the Department's overarching compliance strategy should be developed and enhanced.

- A Joint Business Tax Forum which brings together senior officials from HM Treasury and HMRC with representatives of major UK companies. This forum examines issues which business and/or HMRC find difficult and looks for solutions. Its focus is mainly operational but policy issues are also considered.
- A joint HMRC/HM Treasury challenge panel, chaired by an Executive Committee member, which tests the plans of individual Directorates to reduce the administrative burden on business and challenges the Directors to be more ambitious. The challenge panel brings together senior representatives of the Business and Individuals Customer Units, Local Compliance and HM Treasury.
- Risk and Intelligence Directorates brought together with the aim of ensuring that all HMRC Enforcement and Compliance activities are directed and supported by the best possible risk and intelligence information. This will facilitate the Department's aim to be a risk driven organisation. This is in line with our customer focused approach where we direct resources to deal with the non-compliant and support those who wish to comply.
- Further work being undertaken to reinforce professionalism across Enforcement and Compliance, for example the establishment of a National Professionalism Group in Detection. This provides an overview of professionalism issues and procedures, and puts in place standard operating procedures and policy changes to correct problems identified. Action is then taken forward in each Region by a Professional Standards Manager.
- Regular, in some cases permanent, participation by Executive Committee members and Directors in the 'Hotseat' on the HMRC Intranet. This allows any member of staff within HMRC to ask questions and provide feedback on relevant matters.

6. Review of effectiveness

6.1 As Principal Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review of the effectiveness of the system of internal control is informed by executive managers within the Department who have responsibility for the development and maintenance of the internal control framework, by the work of the internal auditors and comments made by NAO in management letters and other reports.

6.2 I discuss significant control issues with my executive team at our regular Executive Committee meetings. These meetings are informed by an assessment of our current exposure to risks associated with our major programmes and projects. They are further informed by feedback from a series of performance reviews held each quarter between the relevant Executive Committee manager and Director. The focus of these reviews is the progress being made in each Director's area to deliver value and the key issues/risks that could prevent the achievement of key targets/objectives by the year end. I also receive a detailed, monthly Management Report, which highlights potential areas of concern.

6.3 To provide me with an assurance on the effectiveness of the system of internal control, the Director of Internal Audit provides me with an annual opinion, a summary of the findings from every internal audit review, and he alerts me to significant control issues as they arise. The Chairman of the Audit Committee, who is a non-executive Board member, provides the Board with a written report after each Audit Committee meeting.

6.4 The Director Generals and other senior managers have drawn up statements that set out the governance, risk and control arrangements in their business areas. Taking these statements into account, and observations from the Director of Internal Audit and from NAO, I recognise that there are a number of significant control weaknesses. These are detailed below. I am giving priority to the plans that we have put in place to address these weaknesses.

Tax Credits

Fraud and Claimant Compliance

6.5 HMRC estimated that in 2004-05 claimant error and fraud resulted in tax credits of between £1.04 billion and £1.30 billion being paid to claimants to which they were not entitled; and that claimant error resulted in between £196 million and £348 million of tax credits not being paid to claimants when they were entitled to them. This compares with claimant error figures in 2003-04 of between £1.06 billion and £1.28 billion being paid to claimants to which they were not entitled; and between £190 million and £280 million not being paid to claimants when they were entitled to them. These estimates led the Comptroller and Auditor General to again qualify his opinion of HMRC's accounts in relation to the 2006-07 Trust Statement.

Software Errors

6.6 ASPIRE, our strategic IT partner, has a Live Service Improvement Plan to improve the performance of the IT live service and manage down the number of software errors in the system. The level of software errors in the tax credits system reflects its complexity and relative immaturity, and in particular the level of development of the system. In general, errors when they occur now only affect a minority of customers.

E-Portal

6.7 In December 2005 the tax credit portal was closed in response to a sustained criminal attack on the tax credit system. We will not re-open the e-portal until we are sure it is secure. An ID Authentication service for the e-portal is currently scheduled for delivery in the summer of 2008, so there is no prospect of it re-opening until after that has been delivered and shown to be effective.

Pay As You Earn (PAYE), Self Assessment (SA) and National Insurance Contributions (NIC)

PAYE

6.8 My statement last year, and part 3 of the NAO's standard report last year, reflected earlier reviews in this area by Internal Audit and commented on the measures HMRC is taking or has planned to address the weaknesses identified. Three main areas are discussed: the handling of multiple income source cases; benefits in kind and open cases.

The handling of multiple income source cases

6.9 Changes in employee work patterns mean it is now much more common for employees to have more than one job at the same time. Following the review of the weaknesses in our processes, the Department has taken steps to ensure staff better understand the need to use all relevant sources of information when reviewing taxpayers' liability. This was also identified as a work priority for 2006-07. From April this year, as a result of the Modernising PAYE Processes for Customers Programme (MPPC), the information about different sources of income for an employee will be brought together into a single figure of earnings and tax deducted for the year from all PAYE sources, making it easier to identify cases where too much or too little tax has been paid. MPPC will introduce further changes from April 2008 to transfer onto, and increase the automation of processing on, the National Insurance (NIRS) system, which will then progressively become the main system which holds and processes PAYE information.

Benefits in kind

6.10 The Department accepts that clerical work associated with coding benefits in kind has not been given sufficiently high priority in the past. Instructions have been issued to staff to place a greater emphasis and priority on this work and changes have been introduced that enable staff to concentrate on cases with the most tax consequence. These measures should double the number of cases worked. The Department is also taking steps to reduce the amount of clerical work needed to code benefits accurately. An existing computer tool has been enhanced to help staff calculate codes more accurately and its use has been made compulsory in all but the simplest of cases. From April this year, we have as part of MPPC introduced IT support to update tax codes automatically to reflect the latest information from employers, further improving accuracy and reducing the number of cases needing to be reviewed after the year end.

Open cases

6.11 The Department has taken a number of measures to reduce the number of PAYE open cases waiting to be worked (cases where the end of year check identifies that clerical action is needed to clear a case). These include the use of additional staff on the work, new IT tools and better management, guidance and training. Early evidence from the use of one of the new IT tools shows that as a result there was no need to contact the employer for further information in 20 per cent of cases. The Department also anticipates that the introduction of an automated consolidation process within MPPC for information from employers on employee earnings will further reduce the number of open cases. Following a rise in open cases in 2006 due to processing delays, we expect the number of cases on hand for March 2007 to be around 13 million. We are continuing to tackle the problem and expect to bring the number of open cases down to 10.5 million by March 2008. The advent of the third phase of MPPC from April 2008 is expected to reduce the number of open cases generated each year, with the result that we expect to further reduce the number of open cases to 7 million by April 2009 and to reach equilibrium in 2009-10 (where the number of cases generated each year are cleared in a year).

New issue

Small Pensions

6.12 In addition, we have recently identified that up to 420,000 small pensions are not being properly taxed through PAYE. We estimate that tax of £135 million per annum remains uncollected as a result. This situation arises from efforts in the 1980s to cut what was perceived at the time to be low value/risk work, in the face of Departmental (Inland Revenue) work pressures. Cases fall into two categories, resulting from:

- Central guidance allowing pension providers to operate a ‘no tax’ regime for new small pensions in certain circumstances;
- Local agreements between processing offices and pension providers which have been excluding some pensions from tax on a ‘de minimis’ basis.

6.13 Neither of these categories has any legislative or regulatory justification and the Directorate is now leading a systematic programme of work to rectify the failings in line with detailed legal advice:

- The incorrect central guidance on new pensions has been changed (since April 2005) and the change is now being reinforced with pension providers;
- Systematic corrective action will be restricted to 2007-08 et seq. though some cases will be corrected for 2006-07 in the normal course of processing work. In line with our legal advice, we do not intend to pursue tax due but not collected for earlier years where this has arisen because of the incorrect central guidance or local arrangements described in para 6.12 above.

National Insurance Contributions

6.14 The level of debt apparently associated with outstanding Class 2 National Insurance Contributions (NICs) is a matter of concern and was also reported on in the 2005-06 NAO standard report. To address the issue, we decided that:

- A Director level group should oversee the issue.
- A review should be undertaken with the aim of recommending proposals for change, including the possibility of the collection of Class 2 liability via the Self Assessment return.

This work has been monitored through the Class 2 NICs Directors Group and the Class 2 Processes Review has recommended a range of minor changes to improve the position, as well as making proposals, subject to Ministerial decisions, for the collection of Class 2 NICs with the SA return.

Control of repayments

6.15 Internal Audit work in 2004-05 identified weaknesses in the operation of processes for control of repayments in SA and PAYE. As a result, a Departmental Steering Group, chaired by the Director of Finance, was established. It is reviewing existing governance arrangements for repayments generally and has initiated work to develop options for improvement.

6.16 In addition, Internal Audit also identified a more general problem with failures to follow existing procedures and processes. We are addressing this in two ways. Firstly, Processing directorates have set up assurance arrangements to check that instructions are being followed. Secondly, our Pacesetter programme includes the implementation of, and adherence to, standard processes across our main activities with regular "workplace assessment checks".

6.17 Organised criminal attacks to obtain fraudulent repayments of self-assessed tax have resulted in reduced Exchequer yield and unwanted increase in the SA population. This is being addressed by the Department's Income Tax Self Assessment Repayments Delivery Group who have been developing, and are now delivering, the changes needed to combat these attacks.

Missing Trader Intra-Community (MTIC) VAT fraud

6.18 This aspect of the VAT Compliance Strategy was reported in the HMRC Statement on Internal Control for 2005-06, when the attempted fraud was estimated at between £3.5 billion and £4.75 billion with an estimated negative impact on VAT receipts during the same year of between £2 billion and £3 billion. These estimates show that the scale of attack from missing trader fraud grew rapidly during the latter part of 2005-06 and early 2006-07. HMRC strengthened its strategy to combat this attack and mutations in the fraud. Operational measures led to a significant reduction in the level of attempted fraud, partially reflected in the rapid fall in the summer 2006 volume and value of trading activity associated with missing trader fraud. Further legal rulings provided us with a strengthened basis to deny suspect VAT repayment claims where the claimant knew or should have known that their transactions were part of a wider fraud. The measures together with the redeployment of over 700 additional compliance officers, meant that a significantly increased number of suspect repayment claims were subject to proportionate and timely investigation and refusal of the claim in appropriate circumstances. These will not be paid unless and until found to be properly payable. We are continuing to pursue monies previously paid out where there are suspicions they were associated with fraud.

6.19 The Government is determined to sustain the impact of the strategy and to ensure that we have the tools we need to combat missing trader fraud. It announced further measures in this year's Budget to extend, from 1 May 2007, the joint and several liability provisions introduced in 2003 to include various types of electronic goods used for entertainment or amusement and a power to amend, by order, the circumstances under which businesses are presumed to have reasonable grounds to suspect that their transactions are connected with a VAT fraud. Following the agreement of EU partners, the Government also announced, on 19 March 2007, the introduction in the UK, from 1 June 2007, of a change in VAT accounting (the reverse charge) for goods most commonly used in missing trader fraud. The reverse charge changes the accounting procedure by requiring the purchaser, rather than the seller, to account for the VAT on the sale of missing trader fraud goods.

Consultancy

6.20 Last year's Statement on Internal Control reported on problems with the procurement of consultancy services and the measures we planned to introduce to ensure tighter controls over consultancy spend across HMRC.

6.21 The specific actions highlighted in last year's statement were:

- Ensuring that by Autumn 2006, fully compliant contracts are in place for all consultancy expenditure – there has been a delay in implementation of the HMRC Specialist Consultancy Framework (SCF), due to requirement clarification and volume of interest, but this is now substantially in place.
- Using the Enterprise Resource Planning system, an integrated accounting and resources package, to enforce authorisation levels – these system controls are in place and we have also taken other action to enhance control, including requiring Chairman authorisation for non-competed engagements over £50,000 and competed engagements over £250,000.
- Reviewing invoices, to provide an assurance that future spending on consultancy is made using these fully compliant contracts – this review will be carried out once the SCF is in place and we have a robust 2007-08 HMRC spend analysis

6.22 In addition to this the following actions have taken place:

- I have asked each of my Directors to provide assurance that they are getting value from their investment in consultants.
- The Chief Finance Officer is carrying out a systemic review of all external contracts in order to reduce spending to an irreducible minimum, consistent with Departmental objectives.
- Commercial Directorate (CD) is leading on developing processes and analyses that will help control spend on consultancy and improve usage across HMRC. Other action CD has taken to enhance governance over consultancy spend includes issue of Commercial Director Notes, development of Intranet guidance and provision of regular management information to the Executive Committee. They have also recently commenced delivery of a business area education programme regarding employment of consultants.

Data Security

6.23 Like many large organisations, HMRC has experienced an increased level of identity fraud, external attacks upon its IT systems and incidents involving data security. Given these, HMRC is taking action to improve the security of data which it holds through a programme designed to raise awareness, clarify accountabilities and introduce process improvements.

Paul Gray
Principal Accounting Officer
3 July 2007

Resource Accounts

Consolidated Resource Accounts for the year ended 31 March 2007

Contents **Page**

The Annual Report

Introduction

1. These Resource Accounts have been prepared under a direction issued by the Treasury Officer of Accounts in accordance with section 7(2) of the Government Resources and Accounts Act 2000. They present the operating costs and financial position of HM Revenue & Customs (HMRC) for the year ended 31 March 2007 and include the Core Department and the Valuation Office Agency (VOA). Figures for the VOA are also published separately in their agency accounts which can be viewed at www.voa.gov.uk.

2. HMRC is responsible for collecting taxes and duties, making payments of tax credits and Child Benefit, collecting repayments of student loans, enforcing payment of the national minimum wage and enforcing Government requirements relating to the movement of goods across the UK national and EU common frontier. More information about the Department's aim and objectives can be found in the Management Commentary (see paragraphs 8 to 10 below).

3. HMRC has a close relationship with the Department for Work and Pensions (DWP) and its counterpart in Northern Ireland, the Department for Social Development (DSD), as they are responsible for the payment of benefits based on National Insurance Contributions. Administrative expenditure relating to the collection of National Insurance Contributions is included in the Operating Cost Statement while associated income recovered from the National Insurance Funds is included as Appropriations in Aid (A in A).

4. Receipts and payments of direct and indirect taxes, National Insurance Contributions and payments of tax credits are accounted for in the Trust Statement which is on pages 73-105 of this publication.

Departmental reporting cycle

5. The Department produces regular reports on its performance which appear as part of the Annual and Spring Reports. The HMRC Annual Report 2005-06 was published in December 2006 (Cm 6983) and the Spring Departmental Report 2007 was published in May 2007 (Cm 7107). These reports are available from The Stationery Office and the HMRC website (www.hmrc.gov.uk). The Autumn Performance Report will be published in December 2007.

6. Details of the VOA objectives and performance can be found in its Annual Report and Accounts (HC 550), which is available from The Stationery Office and the VOA website (www.voa.gov.uk).

7. Pension benefits are provided through the Civil Service pension arrangement (see note 1.12 and the Remuneration Report).

Management Commentary

Departmental aim and objectives

8. The aim of HM Revenue & Customs (HMRC) is to administer the tax and customs control systems fairly and efficiently and make it as easy as possible for individuals and businesses to understand and comply with their obligations and receive their tax credit and other entitlements.

9. The Department has the following strategic objectives:

   - To improve the extent to which individuals and businesses pay the amount of tax due and receive the credits and payments to which they are entitled.

- Improve customer experience, support business and reduce the compliance burden.
- Strengthen frontier protection against threats to the security, social and economic integrity and environment of the United Kingdom in a way that balances the need to maintain the UK as a competitive location in which to do business.

10. These objectives can be subdivided into five Requests for Resources as described in the 'Consolidated Statement of Operating Costs by Departmental Aim and Objectives' of these Resource Accounts (see page 36).

The Department's efficiency challenge

11. Following the 2004 Spending Review, HMRC has been set stretching targets to achieve efficiency savings of at least £507m and reduce full-time equivalent (FTE) posts by 16,000 gross, 12,500 net of redeployments to front-line work by April 2008.
12. The performance of HMRC is assessed through its Public Service Agreement (PSA), Service Delivery Agreement (SDA) and other work targets. Performance targets for 2006-07 are set out in the Spending Review 2004 for the period 2005-08. Full details of performance against those targets are reported in the Board's Annual Report and the Spring and Autumn Performance Reports.

Financial position and results for the year

Financial results

13. A 3-year settlement provided pay awards for 2005, 2006 and 2007. The Department implemented an assimilation exercise in 2006 to ensure that all staff from the former Departments were brought into line with each other and received the appropriate salary. The Department is now beginning the process of considering the reward strategy for 2008 onwards. It will be consulting with businesses, HM Treasury and other key stakeholders (see note 9).
14. Child Benefit and Child Trust Fund are accounted for within programme costs in the Operating Cost Statement (OCS) (see note 11). Additional information concerning Child Benefit and Child Trust Fund payments is published in the Department's Annual Spring Report.
15. Details of the Department's significant provisions are reported in note 21.
16. The Department has two significant Private Finance Initiative (PFI) contracts, which are included within these Resource Accounts:
    - Mapeley contract for private sector ownership and management of the Departmental estate. This is a joint contract with the former two Departments (which also covers the Valuation Office Agency). The contract provides serviced accommodation for 20 years.
    - Exchequer Partnerships contract for private sector ownership of 100 Parliament Street. The Department relocated a substantial part of Head Office function to 100 Parliament Street in November 2004. The contract provides serviced accommodation for 33 years.
17. In addition, the Department has a significant IT contract (non PFI), which is included within these Resource Accounts. The Capgemini contract is to deliver high standards of IT infrastructure. This is a joint contract with HM Revenue & Customs and VOA. Under the contract, Capgemini provides user services for desktop, business applications management, enhancements and development, projects, new projects integration services (including the testing of applications and infrastructure), as well as services to all HMRC and VOA departments. They also lead on business transformation consulting.

18. The Serious Organised Crime Agency (SOCA) is an Executive Non-Departmental Public Body sponsored by, but operationally independent from, the Home Office. The Agency has been formed from the amalgamation of the National Crime Squad (NCS), National Criminal Intelligence Service (NCIS), that part of HMRC dealing with drug trafficking and associated criminal finance and a part of UK Immigration dealing with organised immigration crime (UKIS). A total of 1,127 HMRC posts, along with assets and the associated resource funding transferred to SOCA from 1 April 2006 (see note 37).

19. The Office of HM Paymaster General (OPG) is a statutory office. It is staffed by civil servants who operate the statutory accounts of the Paymaster General at the Bank of England under delegated authority. A total of 8 posts, along with assets and the associated resource funding transferred from HM Treasury from 1 April 2006 (see note 37).

Comparison Outturn against Estimate

20. Expenditure outturn for the year was £15,029.4m, £57.6m (0.4 per cent) below the Estimate. The variances which exceed 10 per cent are explained below as required by the Government Financial Reporting Manual (FReM).

    Request for resources 4 (RfR 4), Payment of Local Authority Rates (POLAR) is underspent by £7.7m (20.9 per cent). There are a number of reasons for this underspend, but significantly there has not been the expected increase in the number of diplomatic premises for which POLAR is payable. This is a demand-led vote and therefore outturn depends on a number of factors which have been difficult to forecast with precision. However, the diplomatic estate now appears to have stabilised, payment agreements have been made with a greater number of missions and the majority of outstanding queries have been cleared. This should result in a more precise estimate for RfR 4 in future years.

Balance sheet

21. The balance sheet of HM Revenue & Customs is dominated by its tangible fixed assets (note 14), which are valued at £1,296.9m (2005-06: £1,196.1m).

22. Other significant assets and liabilities include:

    - creditors (amounts falling due within one year) of £1,132.2m (note 20).
    - debtors of £442.4m (falling due within one year) of which £267.7m relates to penalties (note 18).
    - provisions of £257.9m mainly relating to early departure costs and Child Trust Fund liabilities (note 21).

Cash flow

23. The net cash inflow for the year of £36.5m for the Department is mainly caused by a lower than expected capital expenditure at year end and a late increase in receipts that were due to the Consolidated Fund.

Reconciliation of resource expenditure between Estimates, Accounts and Budgets

	2006-07	2005-06
	£m	£m
Net Resource Outturn (Estimates)	**15,087.0**	**14,407.9**
Adjustments to remove:		
Provision voted for earlier years	–	–
Adjustments to additionally include:		
Non-voted expenditure in the OCS	–	–
Consolidated Fund Extra Receipts in the OCS	–	(3.9)
Other adjustments	–	–
Net Operating Cost (Accounts)	**15,087.0**	**14,404.0**
Adjustments to remove:		
Gains/losses from sale of capital assets	–	(17.4)
Capital grants	(241.5)	(234.8)
European Union income and related adjustments	–	–
Voted expenditure outside the budget	–	–
Adjustments to additionally include:		
Other Consolidated Fund Extra Receipts	–	–
Resource consumption of non-departmental public bodies	–	–
Unallocated resource provision	–	–
Other adjustments [1]	15,112.9	13,452.2
Resource Budget Outturn (Budget)	**29,958.5**	**27,604.0**
of which		
Departmental Expenditure Limits (DEL)	4,619.1	4,392.8
Annually Managed Expenditure (AME)	25,340.9	23,211.2

[1] The figure of £15,112.9m (2005-06: £13,452.2m) relates to the estimated Annually Managed Expenditure that is classified as non-voted by HM Treasury and which is accounted for in the Trust Statement. Tax credits make up the majority of this adjustment £13,989.0m (2005-06: £12,895.0m).

Management

Ministers and senior managers

24. The Remuneration Report (page 21) identifies those senior managers who are members of the Executive Committee.

Register of interests

25. Senior managers within HMRC are required to complete a declaration of any interests. No significant company directorships or other interests were held by Board members which may have conflicted with their management responsibilities. Details of the related party interests of members of the Board, including non-executives, are shown in note 34 to the accounts.

Diversity and equality

26. As a major employer and one of the largest government departments, HMRC has a large part to play in implementing the Government's policies on diversity and equality. The Department's goal is to become a flagship organisation, leading by example and demonstrating that diversity is an integral part of our working life.

27. The Department has developed a comprehensive Diversity Action Plan that will enable us to meet our legislative imperatives, business objectives and our obligations in the Cabinet Office 10-point plan. Specific responsibilities have been assigned to Board members and Directors for both internal and external activities.

28. The Department's policy on the employment of people with disabilities is detailed on the external website. HMRC makes reasonable adjustments for employees with disabilities, and to the recruitment process. Further details are at www.hmrc.gov.uk.

Payment of suppliers

29. The Department aims to pay suppliers within 30 days of the later of: receipt of goods or services; or receipt of a valid invoice or similar demand for payment, unless alternative arrangements have been agreed. During the early part of 2006-07 start up difficulties resulting from the introduction of a new payment system meant this target was not met, giving an annual achievement of 89.8 per cent (2005-06: 98.7 per cent). Performance improved significantly in the second half of the year with an average of 94.6 per cent being achieved.

Communications

30. The Department has a long standing policy of actively informing and consulting its staff and their representatives through a number of well defined and established channels. A variety of channels are employed, including Board question time, email alerts, intranet pages, team briefing, newsletters, staff surveys and the staff magazine 'OneHMRC', and regular meetings and discussions with trade union representatives.

Sustainable development

31. HMRC is fully committed to ensuring that sustainable development objectives set out in the UK Sustainable Development Strategy – Securing the Future, published in March 2005, should underpin the way we meet our operational responsibilities and manage our estate.

    - As the Department responsible for administering environmental taxes – Climate Change Levy, Aggregates Levy and Landfill Tax, HMRC has a direct role to play in combating climate change and protecting the environment. Our border control responsibilities also mean that we play a key role: prohibiting the importation of environmentally damaging material; protecting endangered species, and preventing crime through the prohibition of drugs, obscene material and other goods that flood the black market. Administering the tax systems fairly and making it as easy as possible for individuals and businesses to comply and receive their tax credit and other entitlements, also has important positive social and economic impacts.

- Our ability to conduct our business and manage our estate sustainedly is measured against the targets for Sustainable Operations on the Government Estate. We developed a Sustainable Development Action Plan in 2006 in line with Securing the Future commitments, to enable us to improve performance in key areas and monitor our progress effectively.

  We have been working closely with our contractors to reduce our energy and water consumption and to increase recycling rates and we have launched a major staff awareness campaign to influence staff to adopt more sustainable work practices.

  Last year we increased the amount of waste that we recycled by 1,380 tonnes an equivalent of 26 per cent on the previous years figures. In 2007 we are aiming to maximise recycling through the implementation of improved recycling arrangements across the whole estate. We are also actively engaging with our business areas to explore how we can reduce the amount of paper we use, which is the largest component of our waste.

- In terms of travel HMRC has already been successful in reducing our business mileage and carbon related emissions. During the four year period 2002-06, HMRC reduced its road travel by over six million miles. Last year HMRC joined the Government's carbon offsetting scheme for air travel and we are planning to extend offsetting arrangements to all travel by 2008. More importantly, we are promoting sustainable travel policies by asking staff to consider if the journey is necessary in the first place and if, for example, telephone conferencing or video conferencing could be used instead. Since October 2006 we have actively discouraged domestic air travel and have supported this line by publishing the CO2 emissions for equivalent journeys by rail and air.

- Our Commercial Directorate is developing the Department's procurement strategy and will be ensuring that minimum environmental standards are complied with. They will also be actively engaging with our suppliers to ensure that the environmental impacts of our contracts are managed as rigorously as possible.

Auditors

32. The Comptroller and Auditor General audits these Resource Accounts in accordance with section 6 of the Government Resources and Accounts Act 2000. The notional charge for these audit services as disclosed in these accounts is £0.7m (2005-06: £0.7m). In addition the Comptroller and Auditor General audits the Trust Statement and it has been agreed that it is also appropriate to reflect the cost of this audit in these Resource Accounts. For 2006-07 the cost of the audit of the Trust Statement amounted to £1.2m (2005-06: £1.2m). As a result the total audit fee reported in these Resource Accounts is £1.9m (2005-06: £1.9m).

33. So far as I am aware, there is no relevant audit information of which the auditors are unaware. I have taken all the steps that I ought to have taken to make myself aware of any relevant audit information and to establish that the auditors are aware of that information.

Paul Gray
Principal Accounting Officer
3 July 2007

Corporate Governance Report

1. Code of Good Practice on Corporate Governance in Central Government Departments

1.1 HM Revenue & Customs (HMRC) complied with the provisions of HM Treasury's Code of Good Practice on Corporate Governance in Central Government Departments in 2006-07. The top-level governance of the Department continues to develop and change. As it does, so we will work to ensure that we continue to comply.

2. Ministerial arrangements

2.1 HMRC is a non-ministerial Department established by the Commissioners for Revenue and Customs Act (CRCA) 2005. HMRC's status as a non-ministerial Department aims to ensure that the administration of the tax system is fair and impartial. The Department is accountable to the Chancellor of the Exchequer for the discharge of all its functions.

2.2 The Chancellor is responsible for setting the strategic objectives for the Department and the UK tax system as a whole. He has delegated responsibility for oversight of the Department to the Paymaster General as Departmental Minister for HMRC. The Financial Secretary to the Treasury has specific responsibility for Excise and gambling duties.

3. The Commissioners

3.1 The Commissioners are responsible under the CRCA for the collection and management of revenue, the enforcement of prohibitions and restrictions, as well as other financial functions e.g. payment of tax credits. They exercise these functions in the name of the Crown.

3.2 The Commissioners are directly accountable to Treasury Ministers and Parliament and are required by the CRCA to comply with any directions of a general nature given to them by HM Treasury. These are principally the Public Service Agreement (PSA) targets and Annual Remit.

3.3 Under the legislation all Commissioners have equal authority but one Commissioner is appointed as Chairman.

3.4 The Chairman has further been appointed by the Prime Minister to be Permanent Secretary of the Department and by HM Treasury to be the Principal Accounting Officer.

3.5 A list of the HMRC Commissioners is shown below:

		(Period – if not full year)
Paul Gray CB	Deputy Chairman	to 31 August 2006
	Interim Chairman and Permanent Head of HMRC	from 1 September 2006
	Chairman and Permanent Head of HMRC	from 27 February 2007
Sir David Varney	Chairman and Permanent Head of HMRC	to 31 August 2006
Mike Eland CB	Director General	
Mike Hanson MBE	Director General and Chief People Officer	
Dave Hartnett CB	Director General	
Stephen Jones	Finance Director	to 31 December 2006
Steve Lamey	Director General and Chief Information Officer	

The Chairman has sought the approval of the Prime Minister and the Queen for Stuart Cruickshank and Bernadette Kenny to be appointed as Commissioners. This is pending.

4. The Department's Key Committees (as at 31 March 2007)

Executive Committee

4.1 The Commissioners, together with the following people, comprise the Executive Committee:

		(Period – if not full year)
Stuart Cruickshank	Director General and Chief Finance Officer	from 18 December 2006
Steve Heminsley	Director of Organisational Development	to 31 December 2006
David Hogg CB	General Counsel and Solicitor	
Chris Hopson	Director of Communications and Marketing	from 4 April 2006
Bernadette Kenny	Director General	

4.2 Together these have portfolios of responsibility that span across the whole of HMRC. The Executive Committee provides the strategic management of HMRC. Its responsibilities include:

- Forming HMRC vision and setting high-level objectives.
- Setting strategic direction and deciding priorities for HMRC.
- Shaping the Department's underpinning behaviours, policies, processes and structures.
- Leading and promoting change to secure improved performance.
- Reviewing overall business planning and performance.
- Ownership and management of key strategic risks.
- Leading HMRC horizon scanning and scenario planning.

4.3 The Executive Committee meets regularly, usually on a weekly basis, and its summary minutes are published on the HMRC Internet site.

4.4 The performance of the Executive Committee is evaluated by the Chairman. The Executive Committee also reviews its own effectiveness on a regular basis as part of the arrangements for each meeting and periodically by various means, for instance coaching, workshops, external scrutiny and formal review.

4.5 It is supported by:

- Operating Committee
- Security Committee
- Senior Appointments Board

The Board

4.6 The Board in 2006-07 comprised the Executive Committee and the non-executive Board members. A list of the non-executive Board members is shown at paragraph 4.13.

4.7 The Board provides supportive challenge, oversight and assurance of the work of the Department. Its primary purpose is to allow Executive and non-executive members to discuss and review key operational and strategic matters – including the development of the future strategy for the Department.

4.8 The Board also provides oversight of HMRC's executive agency, the Valuation Office Agency.

4.9 The objectives of the Board include to:

- Contribute at an early stage to the development of strategic and operational proposals.
- Provide advice on the achievement of performance objectives.
- Assess and advise on the management of risk, supported by the Audit Committee.
- Encourage enterprise and innovation.
- Oversee the Department's governance arrangements.

4.10 The Board met eleven times during 2006-07 and its minutes are published on the HMRC Internet site.

4.11 The Chairman leads an annual evaluation of the performance of the Board. Every two years, the Board considers its remit, constitution and operating procedures.

4.12 The Board has three sub-committees that report to it on a regular basis:

- Audit Committee
- People Committee
- Corporate Social Responsibility Steering Group

Non-Executive Board Members

4.13 The non-executive Board members during 2006-07 were as follows:

	(Period – if not full year)
Kate Dunlop	from 1 January 2007
Bill Griffiths	
Mark Haysom	
Nick Macpherson	
Penny Melville-Brown	
Kate Owen	
John Spence OBE	
Sir David Varney	from 1 September to 31 December 2006

4.14 All of the non-executive members are considered to be independent of HMRC being neither Commissioners nor officers of HMRC. Nick Macpherson, and Sir David Varney up to 31 December, have clear and acknowledged relationships with HMRC as representatives of HM Treasury. Their role is to facilitate closer working with HM Treasury and, through their knowledge and experience, to aid better strategic decision-making by the Board. Arrangements are in place to safeguard taxpayer confidentiality by ensuring that neither the non-executive members nor HM Treasury representatives participate in decisions involving specific tax matters.

4.15 The non-executive Board members provide constructive challenge to decisions and processes, drawing on their knowledge and expertise. They do this primarily through their attendance at Board and sub-committee meetings but also through visits and meetings with staff.

4.16 The Chairman, as Permanent Head of HMRC, holds meetings periodically with the independent non-executive members, as a group and individually, without the executives present.

4.17 HMRC has a rigorous, fair and open process for the selection and appointment of non-executive Board members. On appointment they undertake a structured induction process.

Audit Committee

4.18 The Audit Committee provides the Chairman, as Principal Accounting Officer, and the Board with independent advice on the effectiveness of the Department's governance, risk and control arrangements.

4.19 In fulfilling this role, the Audit Committee reviews significant issues identified by Internal Audit (IA) and the National Audit Office (NAO), and invites executive managers to attend and provide an account of action being taken to address these issues.

4.20 Specific areas that come within the remit of the Audit Committee include:

- Strategic processes for governance, risk management and control.
- Departmental Accounts and the Annual Report.
- Statements on Internal Control (SICs).
- Planned activity and results of IA and NAO.

4.21 Membership of the Audit Committee is drawn exclusively from non-executive Board members. In 2006-07 the members were:

- Bill Griffiths (Chairman)
- Kate Owen
- John Spence

4.22 A number of standing invitees also attend Audit Committee meetings. These include the Chief Finance Officer and other Executive Committee members, the Head of Corporate Governance, the Director Internal Audit and representatives from NAO.

4.23 The Audit Committee Chairman evaluates the performance of the committee in regular meetings with Audit Committee members and reports on performance to the HMRC Chairman.

4.24 The Audit Committee met seven times during 2006-07 and the Chair provided a written report to the Board after each meeting. Its terms of reference and minutes of meetings are published on the HMRC Internet site.

4.25 During 2006-07 the Audit Committee reviewed the Department's arrangements for allowing staff a channel to raise concerns outside the normal line management chain. They continue to monitor these arrangements.

5. Other Senior Committees

5.1 **The Operating Committee** in 2006-07 was chaired by an Executive Committee member and comprised a mixture of Executive Committee members and key Directors. It supported the Executive Committee by providing a weekly oversight of the Department's day to day business. This included the identification and resolution of interdependencies between different business units; ensuring the Department was on target to meet its PSA targets; providing the Executive Committee with an 'early warning' system for all key risks and reviewing major change projects and programmes.

5.2 **The Security Committee** in 2006-07 was chaired by an Executive Committee member and comprised senior representatives of the Security Directorate and the business units. It supported the Executive Committee by monitoring and challenging HMRC's exposure to security risks and by providing a strategic view of security and business continuity performance and priorities.

5.3 **The Senior Appointments Board** in 2006-07 was chaired by the Chairman and comprised members of the Executive Committee and the Director HR and Learning. It supported the Executive Committee by considering appointment, succession planning, and development issues relating to the Senior Civil Service.

5.4 **The People Committee** in 2006-07 was chaired by a non-executive Board member and comprised Executive Committee members and business Directors. It supported the Board by providing assurance on all aspects of people issues, ensuring that the Department's policies and systems benefited from independent views and strategic consideration at a high-level.

5.5 **The Corporate Responsibility Steering Group** in 2006-07 was chaired by a non-executive Board member. It comprised a further non-executive Board member, HMRC Directors and representatives from key external partner organisations. It supported the Board in developing and delivering an HMRC corporate responsibility programme by bringing an independent external perspective to the programme and identifying opportunities for enhancing the Department's Corporate Responsibility performance.

5.6 The Executive Committee has agreed to introduce a new committee structure in 2007-08. Through this it aims to increase the depth of discussion on key activities while providing a broader framework of engagement between the Executive Committee, non-executive Board members, Directors and other key managers. The new structure will be embedded during the year and will be reported on in detail in the 2007-08 Corporate Governance Report.

6. Structure of the Department

6.1 The organisational structure of HMRC is based on four inter-related work groups:

- **Operations.** This covers the vast majority of staff and focuses on delivering high quality, cost effective services. The core activities are delivering customer contact, processing and operational compliance, enforcement capabilities and debt management and banking.
- **Corporate Functions.** These guide and support HMRC. Fourteen business units deliver customer focused services such as HR and Learning, Estates & Support Services, Communications and Marketing and Information Management.
- **Product and Process Groups.** Products can be defined as taxes, duties, credits and benefits. Processes are the schemes by which products are delivered. Staff in these six units are responsible for design, specification and providing advice, carrying out technical policy work and liaising with HM Treasury and Ministers.
- **Customer Units.** Two units focus on identifying and understanding the requirements and behaviours of our customers, and the risks associated with them so that HMRC can improve the customer experience and overall compliance.

7. Relationships with Arms Length Bodies

7.1 HMRC has no arms length bodies.

Remuneration Report

Remuneration Policy

The remuneration of senior civil servants is set by the Prime Minister following independent advice from the Review Body on Senior Salaries.

In reaching its recommendations, the Review Body has regard to the following considerations:

- the need to recruit, retain and motivate suitably able and qualified people to exercise their different responsibilities;
- regional/local variations in labour markets and their effects on the recruitment and retention of staff;
- Government policies for improving the public services including the requirement on departments to meet the output targets for the delivery of the departmental services;
- the funds available to departments as set out in the Government's departmental expenditure limits;
- the Government's inflation target.

The Review Body takes account of the evidence it receives about wider economic considerations and the affordability of its recommendations.

Further information about the work of the Review Body can be found at www.ome.uk.com.

Service Contracts

Civil Service appointments are made in accordance with the Civil Service Commissioners' Recruitment Code, which requires appointment to be on merit on the basis of fair and open competition but also includes the circumstances when appointments may otherwise be made. The HMRC Board is advised by a Senior Appointments Board who approve top-level appointments.

Unless otherwise stated below, the officials covered by this report hold appointments, which are open-ended until they retire. Early termination, other than for misconduct, would result in the individual receiving compensation as set out in the Civil Service Compensation Scheme.

Steve Lamey was appointed on a four-year contract commencing on 18 October 2004 and Stuart Cruickshank was appointed on a three-year contract commencing on 18 December 2006. Both have standard notice periods of three months from the employee and five weeks from the employer. No provision for compensation payments or other arrangements have been made in their contracts in the event of early termination of the contract.

Non-executive Board members are appointed for a fixed term of usually three years.

Further information about the work of the Civil Service Commissioners can be found at www.civilservicecommissioners.gov.uk.

There have been no awards or compensation payments made to former senior managers during 2006-07.

There have been no amounts payable to third parties for services of a senior manager for 2006-07.

The following sections provide details of the remuneration and pension interests of the senior officials of the Department.

Remuneration:

	2006-07 Salary £000	2006-07 Benefits in kind (to the nearest £100)	2005-06 Salary £000	2005-06 Benefits in kind (to the nearest £100)
Paul Gray CB	165-170	33,900	155-160	31,900
Sir David Varney (to 31 August 2006)	80-85 (175-180 full year equivalent)	9,000	170-175	20,400
Mike Eland CB	150-155	–	145-150	–
Mike Hanson MBE	135-140	–	125-130	–
Dave Hartnett CB	150-155	–	140-145	–
Stephen Jones (to 31 December 2006)	95-100 (125-130 full year equivalent)	–	110-115	–
Steve Lamey	240-245	900	245-250	9,100
Stuart Cruickshank (from 18 December 2006)	50-55 (175-180 full year equivalent)	–	-	–
Steve Heminsley (to 31 December 2006)	80-85 (105-110 full year equivalent)	–	105-110	–
David Hogg CB	150-155	–	135-140	–
Chris Hopson (from 4 April 2006)	155-160	–	–	–
Bernadette Kenny	130-135	–	50-55 (100-105 full year equivalent)	–

Salary

Salary and allowances covers both pensionable and non-pensionable amounts and includes gross salary; performance pay or bonuses; overtime; reserved rights to London weighting or London allowances; recruitment and retention allowances; private office allowances and any other allowance to the extent that it is subject to UK taxation. This presentation is based on payments made by the Department and thus recorded in these accounts.

Benefits in kind

The monetary value of benefits in kind covers any benefits provided by the employer and treated by HM Revenue & Customs as a taxable emolument. Paul Gray CB and Sir David Varney had the private use of an allocated car in the circumstances permitted by the Civil Service Management Code. Steve Lamey had a benefit in kind relating to taxi journeys.

The Department's Board comprises both senior operational management and external appointees. The remuneration of senior management is included above. External Board appointees' remuneration excluding pension contributions was in the following ranges:

	2006-07 Fees £000	**2005-06** Fees £000
Kate Dunlop (from 1 January 2007)	0-5 (15-20 full year equivalent)	–
Bill Griffiths	20-25	20-25
Mark Haysom	15-20	5-10 (15-20 full year equivalent)
Nick Macpherson[1]	–	–
Penny Melville-Brown	15-20	0-5 (15-20 full year equivalent)
Kate Owen	20-25	20-25
John Spence OBE	20-25	10-15 (20-25 full year equivalent)
Sir David Varney[1] (from 1 September to 31 December 2006)	–	–

[1] *Nick Macpherson and Sir David Varney were paid by HM Treasury.*

Pension Benefits

	Total accrued pension at age 60 at 31 March 2007 and related lump sum £000	Real increase in pension and related lump sum at age 60 £000	CETV at 31 March 2007 (to the nearest £000)	CETV at 31 March 2006 (to the nearest £000)	Real increase in CETV (to the nearest £000)	Employer contribution to partnership pension account (to the nearest £100)
Paul Gray CB [1]	90-95	2.5-5.0	1,786	1,615	92	–
Sir David Varney [1] (to 31 August 2006)	0-5.0	0-2.5	76	58	16	–
Mike Eland CB [2]	55-60 (Plus 165-170 lump sum)	0-2.5 (Plus 0-2.5 lump sum)	1,120	1,116	–	–
Mike Hanson MBE [2]	50-55 (Plus 150-155 lump sum)	0-2.5 (Plus 2.5-5.0 lump sum)	1,138	1,064	35	–
Dave Hartnett CB [3]	55-60 (Plus 130-135 lump sum)	0-2.5 (Plus 0-2.5 lump sum)	1,158	1,104	9	–
Stephen Jones [3] (to 31 December 2006)	40-45 (Plus 105-110 lump sum)	0-2.5 (Plus 0-2.5 lump sum)	813	749	22	–
Steve Lamey [1]	5.0-10.0	0-2.5	89	52	18	–
Stuart Cruickshank [1] (from 18 December 2006)	0-5.0	0-2.5	11	–	7	–
Steve Heminsley [2] (to 31 December 2006)	45-50 (Plus 135-140 lump sum)	0-2.5 (Plus 0-2.5 lump sum)	990	938	1	–
David Hogg CB [2]	65-70 (Plus 195-200 lump sum)	2.5-5.0 (Plus 5.0-10.0 lump sum)	1,644	1,392	196	–
Chris Hopson [1] (from 4 April 2006)	0-5.0	0-2.5	55	30	17	–
Bernadette Kenny [2]	35-40 (Plus 115-120 lump sum)	7.5-10.0 (Plus 20-25 lump sum)	692	543	135	–

[1] *Member of the Premium Scheme, lump sum not applicable*

[2] *Member of the Classic Scheme*

[3] *Member of the Classic Plus Scheme*

Civil Service Pensions

Pension benefits are provided through the Civil Service pension arrangements. From 1 October 2002, civil servants may be in one of three statutory based 'final salary' defined benefit schemes (classic, premium and classic plus). The Schemes are unfunded with the cost of benefits met by monies voted by Parliament each year. Pensions payable under classic, premium and classic plus are increased annually in line with changes in the Retail Prices Index. New entrants after 1 October 2002 may choose between membership of premium or joining a good quality 'money purchase' stakeholder arrangement with a significant employer contribution (partnership pension account).

Employee contributions are set at the rate of 1.5 per cent of pensionable earnings for classic and 3.5 per cent for premium and classic plus. Benefits in classic accrue at the rate of 1/80th of pensionable salary for each year of service. In addition, a lump sum equivalent to three years' pension is payable on retirement. For premium, benefits accrue at the rate of 1/60th of final pensionable earnings for each year of service. Unlike classic, there is no automatic lump sum (but members may give up (commute) some of their pension to provide a lump sum). Classic plus is essentially a variation of premium, but with benefits in respect of service before 1 October 2002 calculated broadly as per classic.

The partnership pension account is a stakeholder pension arrangement. The employer makes a basic contribution of between 3 per cent and 12.5 per cent (depending on the age of the member) into a stakeholder pension product chosen by the employee. The employee does not have to contribute but where they do make contributions, the employer will match these up to a limit of 3 per cent of pensionable salary (in addition to the employer's basic contribution). Employers also contribute a further 0.8 per cent of pensionable salary to cover the cost of centrally-provided risk benefit cover (death in service and ill health retirement).

The accrued pension quoted is the pension the member is entitled to receive when they reach 60, or immediately on ceasing to be an active member of the scheme if they are already 60.

Further details about the Civil Service pension arrangements can be found at the website www.civilservice-pensions.gov.uk

Cash Equivalent Transfer Values

A Cash Equivalent Transfer Value (CETV) is the actuarially assessed capitalised value of the pension scheme benefits accrued by a member at a particular point in time. The benefits valued are the member's accrued benefits and any contingent spouse's pension payable from the scheme. A CETV is a payment made by a pension scheme or arrangement to secure pension benefits in another pension scheme or arrangement when the member leaves a scheme and chooses to transfer the benefits accrued in their former scheme. The pension figures shown relate to the benefits that the individual has accrued as a consequence of their total membership of the pension scheme, not just their service in a senior capacity to which disclosure applies. The CETV figures, and from 2003-04 the other pension details, include the value of any pension benefit in another scheme or arrangement which the individual has transferred to the Civil Service pension arrangements and for which the Cabinet Office's Civil Superannuation Vote has received a transfer payment commensurate to the additional pension liabilities being assumed. They also include any additional pension benefit accrued to the member as a result of their purchasing additional years of pension service in the scheme at their own cost. CETVs are calculated within the guidelines and framework prescribed by the Institute and Faculty of Actuaries.

Real Increase in CETV

This reflects the increase in CETV effectively funded by the employer. It does not include the increase in accrued pension due to inflation, contributions paid by the employee (including the value of any benefits transferred from another pension scheme or arrangement) and uses common market valuation factors for the start and end of the period.

Paul Gray
Principal Accounting Officer
3 July 2007

Statement of Accounting Officer's Responsibilities

Under the Government Resources and Accounts Act 2000, HM Treasury has directed HM Revenue & Customs to prepare, for each financial year, Resource Accounts detailing the resources acquired, held or disposed of during the year and the use of resources by the Department during the year. The accounts are prepared on an accruals basis and must give a true and fair view of the state of affairs of the Department and of its net resource outturn, resources applied to objectives, recognised gains and losses and cash flows for the financial year.

In preparing the accounts, the Principal Accounting Officer is required to comply with the requirements of the Government Financial Reporting Manual and in particular to:

- observe the accounts direction issued by HM Treasury, including the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;
- make judgements and estimates on a reasonable basis;
- state whether applicable accounting standards as set out in the Government Financial Reporting Manual have been followed, and disclose and explain any material departures in the accounts; and
- prepare the accounts on a going concern basis.

HM Treasury has appointed the Permanent Head of the Department as Principal Accounting Officer of the Department. In addition, HM Treasury has appointed Additional Accounting Officers to be accountable for those parts of the Department's accounts relating to specified requests for resources and the associated assets, liabilities and cash flows. These appointments do not detract from the Head of Department's overall responsibility as Accounting Officer for the Department's accounts.

The allocation of Accounting Officer responsibilities in the Department is as follows:

For the period 1 April 2006 to 31 August 2006 the Principal Accounting Officer was Sir David Varney. He was supported by the following Additional Accounting Officers:

- Paul Gray, in respect of
  Request for resources 1:
  Administering the tax and customs control systems fairly and efficiently and making it as easy as possible for individuals and businesses to understand and comply with their obligations and receive their tax credits and other entitlements.
  Request for resources 5:
  Payments of Child Benefit and Child Trust Fund endowments.
- Dave Hartnett, in respect of
  Request for resources 3:
  Providing payments in lieu of tax relief on certain bodies.
- Andrew Hudson, in respect of
  Request for resources 2:
  Growing a contribution to the good management of property where the public interest is involved.
  Request for resources 4:
  Making payment of rates to Local Authorities on behalf of certain bodies.

With effect from 1 September 2006 Paul Gray was appointed Principal Accounting Officer following his appointment as Interim Chairman of HM Revenue & Customs. At the same time, the following Additional Accounting Officers were appointed:

- Mike Eland, in respect of
  Request for resources 1:
  Administering the tax and customs control systems fairly and efficiently and making it as easy as possible for individuals and businesses to understand and comply with their obligations and receive their tax credits and other entitlements.
  Request for resources 5:
  Payments of Child Benefit, Child Trust Fund endowments and associated non-cash items.
- Dave Hartnett continues to have responsibility for
  Request for resources 3:
  Providing payments in lieu of tax relief on certain bodies i.e. transitional payments to charities, supplements on payroll giving, donations to charities and on personal and stakeholder pension schemes, life assurance premium relief, stamp duty relief and residual payments for mortgage interest relief, vocational training relief and private medical insurance.
- Andrew Hudson continues to have responsibility for
  Request for resources 2:
  Administration costs incurred by the Valuation Office in administering the beneficial portion of rates and providing or securing valuation and other services.
  Request for resources 4:
  Payment of rates to Local Authorities in respect of premises occupied by foreign and Commonwealth governments for diplomatic purposes and premises occupied by certain international organisations.

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which the Accounting Officer is answerable, for keeping proper records and for safeguarding the Department's assets, are set out in the Accounting Officers' Memorandum issued by HM Treasury and published in Government Accounting. Under the terms of the Accounting Officers' Memorandum, the relationship between the Department's principal and additional Accounting Officers, together with their respective responsibilities, is set out in writing.

Statement on Internal Control

The Department's Statement on Internal Control, covering both the Resource Accounts and the Trust Statement, is shown on pages 1 to 8

The Certificate and Report of the Comptroller and Auditor General to the House of Commons

I certify that I have audited the financial statements of HM Revenue & Customs for the year ended 31 March 2007 under the Government Resources and Accounts Act 2000. These comprise the Statement of Parliamentary Supply, the Operating Cost Statement and Statement of Recognised Gains and Losses, the Balance Sheet, the Cashflow Statement and the Statement of Operating Costs by Departmental Aim and Objectives and the related notes. These financial statements have been prepared under the accounting policies set out within them. I have also audited the information in the Remuneration Report that is described in that report as having been audited.

Respective responsibilities of the Accounting Officer and auditor

The Accounting Officer is responsible for preparing the Annual Report, which includes the Remuneration Report, and the financial statements in accordance with the Government Resources and Accounts Act 2000 and HM Treasury directions made thereunder and for ensuring the regularity of financial transactions. These responsibilities are set out in the Statement of Accounting Officer's Responsibilities.

My responsibility is to audit the financial statements and the part of the Remuneration Report to be audited in accordance with relevant legal and regulatory requirements, and with International Standards on Auditing (UK and Ireland).

I report to you my opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with HM Treasury directions issued under the Government Resources and Accounts Act 2000. I report to you whether, in my opinion, certain information given in the Annual Report, which comprises the Introduction, the Management Commentary, the Corporate Governance Report and the unaudited part of the Remuneration Report, is consistent with the financial statements. I also report whether in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

In addition, I report to you if the Department has not kept proper accounting records, if I have not received all the information and explanations I require for my audit, or if information specified by HM Treasury regarding remuneration and other transactions is not disclosed.

I review whether the Statement on Internal Control reflects the Department's compliance with HM Treasury's guidance, and I report if it does not. I am not required to consider whether this statement covers all risks and controls, or to form an opinion on the effectiveness of the Department's corporate governance procedures or its risk and control procedures.

I read the other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. I consider the implications for my certificate if I become aware of any apparent misstatements or material inconsistencies with the financial statements. My responsibilities do not extend to any other information.

Basis of audit opinion

I conducted my audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. My audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of financial transactions included in the financial statements and the part of the Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgements made by the Accounting Officer in the preparation of the financial statements, and of whether the accounting policies are most appropriate to the Department's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the financial statements and the part of the Remuneration Report to be audited are free from material misstatement, whether caused by fraud or error, and that in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Remuneration Report to be audited.

Opinions

Audit Opinion

In my opinion:

- the financial statements give a true and fair view, in accordance with the Government Resources and Accounts Act 2000 and directions made thereunder by HM Treasury, of the state of the Department's affairs as at 31 March 2007, and the net cash requirement, net resource outturn, net operating cost, operating costs applied to objectives, recognised gains and losses and cashflows for the year then ended;
- the financial statements and the part of the Remuneration Report to be audited have been properly prepared in accordance with HM Treasury directions issued under the Government Resources and Accounts Act 2000; and
- the information given within the Annual Report, which comprises the Introduction, the Management Commentary, the Corporate Governance Report and the unaudited part of the Remuneration Report is consistent with the financial statements.

Audit Opinion on Regularity

In my opinion, in all material respects, the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

Report

I have no observations to make on these financial statements.

John Bourn
Comptroller and Auditor General
6 July 2007

National Audit Office
157-197 Buckingham Palace Road
Victoria, London SW1W 9SP

The maintenance and integrity of the HM Revenue and Customs' website is the responsibility of the Accounting Officer; the work carried out by the auditors does not involve consideration of these matters and accordingly the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

Statement of Parliamentary Supply

Summary of Resource Outturn 2006-07

								2006-07 £m	Restated* 2005-06 £m
				Estimate			**Outturn**		**Outturn**
Request for Resources	Note	Gross Expenditure	A in A	Net Total	Gross Expenditure	A in A	Net Total	Net Total outturn compared with Estimate: saving/ (excess)	Net Total
RfR 1: Administration	2	5,002.0	(435.9)	4,566.1	4,981.4	(433.6)	4,547.8	18.3	4,311.5
RfR 2: Valuation Office Agency	2	223.1	(223.1)	–	201.9	(201.9)	–	–	–
RfR 3: Payments in lieu of tax relief	2	82.0	–	82.0	80.5	–	80.5	1.5	78.3
RfR 4: Payments of Local Authority Rates	2	41.1	(4.2)	36.9	33.3	(4.1)	29.2	7.7	29.3
RfR 5: Child Benefit and Child Trust Fund	2	10,402.0	–	10,402.0	10,371.9	–	10,371.9	30.1	9,983.7
Total resources	3	**15,750.2**	**(663.2)**	**15,087.0**	**15,669.0**	**(639.6)**	**15,029.4**	**57.6**	**14,402.8**
Non-operating cost A in A				**4.0**			**3.8**	**0.2**	**0.7**

Net cash requirement 2006-07

				2006-07 £m	2005-06 £m
	Note	Estimate	Outturn	Net Total outturn compared with Estimate: saving/ (excess)	Outturn
Net cash requirement	4	**15,370.5**	**15,229.2**	**141.3**	**14,775.1**

**Certain prior year figures have been restated as per note 37.*

Summary of income payable to the Consolidated Fund

In addition to Appropriations in Aid, the following income relates to the Department and is payable to the Consolidated Fund (cash receipts being shown in italics).

		Forecast 2006-07 £m		Outturn 2006-07 £m	
	Note	Income	Receipts	Income	Receipts
Total	5	**(230.0)**	***(230.0)***	**(322.3)**	***(290.9)***

Explanations of variances between Estimate and outturn are given in note 2 and in the Management Commentary.

The notes on pages 37 to 71 form part of these accounts

Operating Cost Statement

for the year ended 31 March 2007

		2006-07 £m						Restated* 2005-06 £m	
		Core Department			Consolidated			Core Department	Consolidated
	Note	Staff Costs	Other Costs	Income	Staff Costs	Other Costs	Income		
Administration Costs:									
Request for resources 1 & 2 –									
Staff costs	9	2,703.2			2,842.5			2,601.8	2,751.3
Other administration costs	10		1,866.4			1,913.2		1,789.2	1,856.0
Operating income	12			(408.2)			(599.6)	(471.1)	(691.3)
Programme Costs:									
Request for resources 1 –									
Staff costs	9	0.1			0.1			0.7	0.7
Programme costs	11		411.7			411.7		403.0	403.0
Income	12			(44.3)			(44.3)	(12.6)	(12.6)
Request for resources 3 – Payments in lieu of tax relief:									
Staff costs	9	–			–			–	–
Programme costs	11		80.5			80.5		78.3	78.3
Income	12			–			–	–	–
Request for resources 4 – Payments of Local Authority Rates:									
Staff costs	9	–			–			–	–
Programme costs	11		–			33.3		–	33.5
Income	12			–			(4.1)	–	(4.2)
Request for resources 5 – Child Benefit and Child Trust Fund:									
Staff costs	9	–			–			–	–
Programme costs	11		10,373.8			10,373.8		9,985.3	9,985.3
Income	12			–			–	–	–
Totals		**2,703.3**	**12,732.4**	**(452.5)**	**2,842.6**	**12,812.5**	**(648.0)**		
Net Operating Cost	3, 13			**14,983.2**			**15,007.1**	**14,374.6**	**14,400.0**

**Certain prior year figures have been restated as per note 37.*

Statement of Recognised Gains and Losses

for the year ended 31 March 2007

	2006-07 £m		2005-06 £m	
	Core Department	Consolidated	Core Department	Consolidated
Net gain/(loss) on revaluation of tangible fixed assets	(20.3)	(19.7)	70.1	71.0
Recognised gains and losses for the financial year	(20.3)	(19.7)	70.1	71.0

The notes on pages 37 to 71 form part of these accounts

Balance Sheet

as at 31 March 2007

	Note	2007 £m Core Department		2007 £m Consolidated		Restated* 2006 £m Core Department		Restated* 2006 £m Consolidated	
Fixed assets:									
Tangible assets	14		1,263.6		1,296.9		1,168.4		1,196.1
Intangible assets	15		8.2		8.2		11.0		11.0
Debtors falling due after more than one year	18		177.5		179.6		192.5		194.7
Current assets:									
Stocks and work in progress	17	8.4		11.7		1.2		4.1	
Debtors	18	434.5		442.4		387.2		396.7	
Cash at bank and in hand	19	75.2		83.7		35.3		47.2	
		518.1		537.8		423.7		448.0	
Creditors (amounts falling due within one year)	20	(1,118.2)		(1,132.2)		(1,145.2)		(1,164.7)	
Net current liabilities			(600.1)		(594.4)		(721.5)		(716.7)
Total assets less current liabilities			849.2		890.3		650.4		685.1
Creditors (amounts falling due after more than one year)	20		(188.6)		(188.6)		(185.6)		(185.6)
Provisions for liabilities and charges	21		(238.7)		(257.9)		(220.4)		(244.1)
			421.9		**443.8**		**244.4**		**255.4**
Taxpayers' equity:									
General fund	22		270.4		289.8		72.6		81.7
Revaluation reserve	23		151.5		154.0		171.8		173.7
			421.9		**443.8**		**244.4**		**255.4**

**Certain prior year figures have been restated as per note 37.*

Paul Gray
Principal Accounting Officer
3 July 2007

Consolidated Cash Flow Statement

for the year ended 31 March 2007

	Note	2006-07 £m	Restated* 2005-06 £m
Net cash outflow from operating activities	24a	(14,906.3)	(14,310.0)
Capital expenditure and financial investment	24b, 24c	(303.8)	(384.3)
Receipts due to the Consolidated Fund which are outside the scope of the Department's activities		266.7	207.6
Payments of amounts due to the Consolidated Fund		(232.2)	(233.7)
Financing from the Consolidated Fund	24d	15,210.2	14,676.6
Financing from the National Insurance Fund	24d	1.9	1.6
Increase/(decrease) in cash in the period	24e	**36.5**	**(42.2)**

**Certain prior year figures have been restated as per note 37.*

Consolidated Statement of Operating Costs by Departmental Aim and Objectives

for the year ended 31 March 2007

						Restated*
			2006-07			**2005-06**
			£m			**£m**
	Gross	**Income**	**Net**	**Gross**	**Income**	**Net**
Aim: To administer the tax and customs control systems fairly and efficiently and make it as easy as possible for individuals and businesses to understand and comply with their obligations and receive their tax credit and other entitlements.						
Objective 1: To improve the extent to which individuals and businesses pay the amount of tax due and receive the credits and payments to which they are entitled.						
Objective 2: Improve customer experience, support business and reduce the compliance burden.						
Objective 3: Strengthen frontier protection against threats to the security, social and economic integrity and environment of the United Kingdom in a way that balances the need to maintain the UK as a competitive location in which to do business.						
We have subdivided these objectives into the following:						
RfR 1: Administering the tax and customs control systems fairly and efficiently and making it as easy as possible for individuals and businesses to understand and comply with their obligations and receive their tax credit and other entitlements.						
Objective 1	3,876.2	(426.1)	3,450.1	3,720.1	(453.5)	3,266.6
Objective 2	643.0	(22.0)	621.0	625.2	(25.1)	600.1
Objective 3	462.2	(4.4)	457.8	449.4	(5.1)	444.3
RfR 2: Growing a contribution to the good management of property where the public interest is involved.	201.9	(207.2)	(5.3)	232.8	(236.7)	(3.9)
RfR 3: Providing payments in lieu of tax relief to certain bodies.	80.5	–	80.5	78.3	–	78.3
RfR 4: Making payments of rates to Local Authorities on behalf of certain bodies.	33.3	(4.1)	29.2	33.5	(4.2)	29.3
RfR 5: Payments of Child Benefit and Child Trust Fund endowments.	10,373.8	–	10,373.8	9,985.3	–	9,985.3
Intra departmental consolidation adjustment	(15.8)	15.8	–	(16.5)	16.5	–
Net Operating Costs	**15,655.1**	**(648.0)**	**15,007.1**	**15,108.1**	**(708.1)**	**14,400.0**

This analysis is approximate, because in practice many activities undertaken by the Department support more than one of the three objectives within RfR 1. Prior year comparatives for Objectives 1-3 have been reapportioned using 2006-07 apportionments due to the change in methodology used to calculate the apportionments for 2006-07.

The intra departmental consolidation adjustment is in respect of transactions between the Department and the Valuation Office Agency.

**Certain prior year figures have been restated as per note 37.*

See note 25

The notes on pages 37 to 71 form part of these accounts

Notes to the Departmental Resource Accounts

1. Statement of Accounting Policies

These financial statements have been prepared in accordance with the 2006-07 *Government Financial Reporting Manual (FReM)* issued by HM Treasury. The accounting policies contained in the *FReM* follow UK Generally Accepted Accounting Practice for companies (UK GAAP) to the extent that it is meaningful and appropriate to the public sector.

In addition to the primary statements prepared under UK GAAP, the *FReM* also requires the Department to prepare two additional primary statements. The *Statement of Parliamentary Supply* and supporting notes show outturn against Estimate in terms of the net resource requirement and the net cash requirement. The consolidated *Statement of Operating Cost by Departmental Aim and Objectives* and supporting notes analyse the Department's income and expenditure by the objectives agreed with Ministers.

Where the *FReM* permits a choice of accounting policy, the accounting policy which has been judged to be most appropriate to the particular circumstances of the Department for the purpose of giving a true and fair view has been selected. The Department's accounting policies have been applied consistently in dealing with items considered material in relation to the accounts.

1.1 Accounting convention

These accounts have been prepared under the historical cost convention modified to account for the revaluation of fixed assets and stocks.

1.2 Basis of consolidation

These accounts comprise a consolidation of the non-agency parts of the Department (the Core Department) and those entities which fall within the Departmental boundary as defined in the *FReM* (chapter 1.5). Transactions between entities included in the consolidation are eliminated.

A list of all those entities within the Departmental boundary is given in note 36.

1.3 Tangible fixed assets

1.3.1 General

With the exceptions stated below concerning furniture utilised by the Core Department, tangible fixed assets are stated at the lower of replacement cost and recoverable amount. A £5,000 capitalisation threshold applies to all tangible fixed assets except for furniture, vehicles and IT hardware, which are capitalised regardless. On initial recognition assets are measured at cost including any costs such as installation directly attributable to bringing them into working condition. Appropriate indices are applied to developed computer software, which have not been formally valued during the year. All other tangible assets (excluding property) are of low value with short lives where the historic cost is considered to be comparable to the modified historic cost had indices been applied.

1.3.2 Property assets

The majority of the property assets occupied by HMRC were acquired from the predecessor Departments by Mapeley STEPS Ltd in March 2001 under a twenty-year Private Finance Initiative (PFI) contract (see note 28.1).

Freehold Land and Buildings at note 14 reports the property asset at 100 Parliament Street. This asset has been stated at existing use value using professional valuations at least every five years.

Accommodation refurbishments at note 14 reports expenditure in respect of major capital refurbishments and improvements of properties occupied but not owned. HMRC policy from April 2005 is to capitalise refurbishments when the project costs exceed £150,000.

1.3.3 Furniture

For the Core Department, the value and depreciation of furniture and fittings are estimated on the basis of the average number of staff accommodated, the average current furniture costs for each employee and the useful economic life ascribed to furniture assets. Actual furniture costs each year are expensed. This methodology provides a reasonable approximation of the actual values and depreciation that would have been available had the Department maintained detailed records for the individual items of furniture, which individually are of relatively low value, but collectively are material to these accounts. Adopting this capitation estimating method avoids the Department having to incur significant costs in maintaining and validating detailed records.

1.3.4 Developed computer software

Computer software, including tax credit software, that has been developed by the Department and its computer service partner, and for which the Department has ownership rights e.g. the corporate tax collecting software, has been capitalised. This capitalisation includes the cost of staff and mainframe resources used in the development of the programs. Upon abolition of a tax or planned replacement, an impairment review is conducted of the asset(s) and the value adjusted accordingly.

1.3.5 Assets under construction

Assets under construction are separately reported in note 14. Costs are accumulated until the asset is completed and brought into service when the asset is transferred to the relevant asset group and depreciation commences.

1.4 Depreciation

Tangible fixed assets are depreciated at rates calculated to write them down to estimated residual values on a straight-line basis over their estimated useful lives. Asset lives are normally in the following ranges:

Asset category	**Estimated useful life**
Freehold land	Not depreciated
Freehold buildings	50 years
Accommodation refurbishments	Period of the lease
Office equipment	7 years
Computer equipment	3 to 5 years
Vehicles	3 to 7 years
Furniture and fittings	10 years
Developed computer software	Remaining economic life not greater than 10 years
Vessels	10 to 20 years
Scientific aids	3 to 12 years
Intangible assets (3rd party software licences)	Remaining economic life not greater than the remaining period of the licence

1.5 Intangible fixed assets

Initial one-off purchased computer software licences are capitalised as intangible fixed assets where expenditure of £5,000 or more is incurred. Software licences are amortised over the shorter of the term of the licence and the useful economic life. Ongoing software licence fees payable at regular intervals are treated as period rentals and charged to the Operating Cost Statement.

1.6 Stocks and work in progress

Stocks are valued at lower of cost and net realisable value. Stocks consist of stationery, purchased uniforms, vessel spare parts and operational equipment.

Work in progress is an accounting estimate mainly determined by applying the lower of selling price and outturn unit cost for each type of work to the number of outstanding cases or projects at year end. It mainly consists of International Assistance project work and Valuation Office Agency case work relating to land services.

1.7 Operating income

Operating income is income which relates directly to the operating activities of the Department. It principally comprises fees and charges to other government departments, agencies, other non-departmental public bodies and external customers for services provided on a full-cost basis. It includes not only income appropriated in aid of the Estimate but also any Consolidated Fund income which, in accordance with the *FReM*, is treated as operating income. Operating income is stated net of VAT.

1.8 Administration and programme expenditure

The Operating Cost Statement is analysed between administration and programme income and expenditure. The classification of expenditure and income as administrative or as programme follows the definition of administration costs set out in the *FReM* by HM Treasury. Administration costs reflect the costs of running the Department. These include both administrative costs and associated operating income. Income is analysed in the notes between that which, under the administrative cost-control regime, is allowed to be offset against gross administrative costs in determining the outturn against the administration cost limit, and that operating income which is not. Programme costs reflect non-administration costs, including Child Benefit and Child Trust Fund payments and other disbursements by the Department, as well as certain staff costs where they relate directly to delivery of these programmes.

1.9 Cash at bank and in hand

These are balances in respect of administering the Department and programme expenditure relating to both Child Benefit and Child Trust Fund, but exclude all tax and duty revenues collected. The latter are included in the Department's Trust Statement.

1.10 Capital charge

A charge, reflecting the cost of capital utilised by the Department, is included in operating costs. The charge is calculated at the real rate set by HM Treasury (currently 3.5 per cent) on the average carrying amount of all assets less liabilities, except for cash balances with the Office of the Paymaster General, where the charge is nil.

1.11 Foreign exchange

Balances held in a foreign currency, including Euro bank balances, are translated into Sterling using the Bank of England rate on the last working day of the month. Other transactions denominated in a foreign currency are translated into Sterling at the rate of exchange ruling on the date of each transaction. Any exchange differences are posted to an expenditure account and are therefore dealt with in the Operating Cost Statement.

1.12 Pensions

Past and present employees are covered by the provisions of the Principal Civil Service Pension Scheme (PCSPS). The defined benefit schemes are unfunded and are non-contributory except in respect of dependants' benefits. The Department recognises the expected cost of these elements on a systematic and rational basis over the period during which it benefits from employees' services by payment to the PCSPS of amounts calculated on an accruing basis. Liability for payment of future benefits is a charge on the PCSPS. In respect of the defined contribution schemes, the Department recognises the contributions payable for the year.

1.13 Leases

Where substantially all risks and rewards of ownership of a leased asset are borne by the Department, the asset is recorded as a tangible fixed asset and a debt is recorded to the lessor of the minimum lease payments discounted by the interest rate implicit in the lease. The interest element of the finance lease payment is charged to the Operating Cost Statement over the period of the lease at a constant rate in relation to the balance outstanding. Other leases are regarded as operating leases and the rentals are charged to the Operating Cost Statement on a straight-line basis over the term of the lease.

1.14 Private Finance Initiative (PFI) contracts

PFI transactions have been accounted for in accordance with Technical Note No.1 (Revised), entitled *How to Account for PFI Transactions* as required by the *FReM*. Where the balance of risks and rewards of ownership of the PFI property are borne by the PFI operator, the PFI payments are recorded as an operating cost. Where the Department has contributed assets, a prepayment for their fair value is recognised and amortised over the life of the PFI contract.

Where the balance of risks and rewards of ownership of the PFI property is borne by the Department, the property is recognised as a fixed asset and the liability to pay for it is accounted for as a finance lease. Contract payments are apportioned between an imputed finance lease charge and a service charge.

1.15 Provisions

The Department provides for legal or constructive obligations which are of uncertain timing or amount at the balance sheet date on the basis of the best estimate of the expenditure required to settle the obligation. Where the effect of the time value of money is significant, the estimated risk-adjusted cash flows are discounted using the real rate set by HM Treasury (currently 2.2 per cent).

1.16 Early departure costs

The Department is required to meet the additional cost of benefits beyond the normal PCSPS benefits in respect of employees who retire early. The Department makes provision in full for this cost when the early retirement programme has been announced and is binding on the Department. The Department has, in certain circumstances, settled some or all of its liability in advance by making a payment to the Paymaster General's account at the Bank of England for credit of the Civil Service Superannuation Vote.

1.17 Provision for doubtful debt

A general provision for doubtful debt has been made in respect of legal costs that have been awarded to the Department. These costs arise as a result of legal proceedings against taxpayers for the recovery of outstanding tax liabilities. A further general provision is made in respect of penalty debtors (note 1.19) to allow for the remission of uncollectable penalties and in respect of Child Benefit debtors to allow for potentially irrecoverable amounts. All these provisions have been estimated having regard to the level of debts not recovered during 2006-07 and earlier years.

1.18 Value Added Tax

Most of the activities of the Department are outside the scope of VAT. In general, output tax does not apply and input tax on purchases is not recoverable. Some input VAT on a restricted number of services is recovered under Section 41(3) of the VAT Act 1994 and in accordance with the HM Treasury 'Contracting-out Direction'. Section 41(3) is intended to remove any disincentive to government departments of contracting-out activities performed 'in-house' where there is a sound basis for doing so. Irrecoverable VAT is charged to the relevant expenditure category or included in the capitalised purchase cost of fixed assets. Income and expenditure is otherwise shown net of VAT.

1.19 Tax penalty income

Income arising from the levying of tax penalties is generally treated as Consolidated Fund Extra Receipts (CFER). However, HM Treasury has given authority for certain penalties relating to Income Tax, Corporation Tax and Capital Gains Tax, to be appropriated in aid by the Department, i.e. kept by the Department to fund the costs of collection.

Further, in accordance with HM Treasury guidance, where it is not possible to distinguish between tax receipts and penalty receipts collectable as part of investigation settlements, the whole amount is accounted for as a tax receipt in the Trust Statement.

Penalties relating to National Insurance Contributions do not appear in these Resource Accounts. They are accounted for as income in the Trust Statement and paid over to the National Insurance Fund.

1.20 Child Benefit

Child Benefit is accounted for within the programme costs in the Operating Cost Statement and includes both Child Benefit and Child Benefit (Lone Parent) Premium. Payments to claimants are recorded as a creditor when the payment falls due. Appropriate accruals and prepayment adjustments are made to ensure that the expenditure arising from the entitlement period of each payment is recorded to the correct month. These adjustments are based on the number of days of the entitlement period falling within each calendar month.

Where an overpayment of benefit is established, a debt is created and programme expenditure in the Operating Cost Statement is reduced accordingly. Where possible, overpayment of debt is recovered from future benefit entitlement. Debt which is deemed irrecoverable is written-off in accordance with the Department's normal remission policy, and recorded as expenditure within the Operating Cost Statement (see also note 1.17).

1.21 Child Trust Fund

The Child Trust Fund (CTF) is a long term savings and investment account for children. CTF accounts became available from 6 April 2005 for eligible children born on or after 1 September 2002. A liability for payment arises when a child is born and the child is eligible for CTF. The payment due at birth could comprise both an initial endowment and a supplementary endowment. All eligible children qualify for the initial endowment, while only those eligible children in families where the family income is below the income threshold for Child Tax Credit purposes in the year of birth will qualify for the supplementary endowment. These payments due, where they remain unpaid, are recognised as either creditors (amounts falling due within one year) or as a provision.

1.22 Third-party assets

On behalf of the Department the Bank of England holds Euro deposits in relation to the European Commission (EC) twinning projects. These assets are not held as part of the Department's activities and as such do not form part of these accounts.

The Department manages interest-bearing accounts containing seized money, and also holds non-monetary assets as physical evidence in connection with ongoing legal proceedings. These assets are held as part of the Department's law enforcement activities and as such do not form part of these accounts.

Details of these assets are reported in note 35.

1.23 Contingent liabilities

In addition to contingent liabilities disclosed in accordance with FRS 12, the Department discloses for parliamentary reporting and accountability purposes certain statutory and non-statutory contingent liabilities where the likelihood of a transfer of economic benefit is remote, but which have been reported to Parliament in accordance with the requirements of *Government Accounting*.

Where the time value of money is material, contingent liabilities which are required to be disclosed under FRS 12 are stated at discounted amounts and the amount reported to Parliament separately noted. Contingent liabilities that are not required to be disclosed by FRS 12 are stated at the amounts reported to Parliament.

2. Analysis of net resource outturn by section

									Restated*
								2006-07 £m	2005-06 £m
	Outturn						Estimate		
	Admin	Other current	Grants	Gross resource expenditure	A in A	Net Total	Net Total	Net Total outturn compared with Estimate	Prior-year outturn
Request for resources 1:									
A. Administration	4,569.7	130.2	2.0	4,701.9	(432.4)	4,269.5	4,271.1	1.6	4,086.3
B. e-filing incentive payments	–	–	278.3	278.3	–	278.3	295.0	16.7	225.2
C. Operational local clearance procedures	–	1.2	–	1.2	(1.2)	–	–	–	–
Total	4,569.7	131.4	280.3	4,981.4	(433.6)	4,547.8	4,566.1	18.3	4,311.5
Request for resources 2:									
A. VOA Administration	201.9	–	–	201.9	(201.9)	–	–	–	–
Request for resources 3:									
A. Payments in lieu of tax relief	–	–	80.5	80.5	–	80.5	82.0	1.5	78.3
Request for resources 4:									
A. Payments of Local Authority Rates	–	33.3	–	33.3	(4.1)	29.2	36.9	7.7	29.3
Request for resources 5:									
A. Children's benefits	–	(14.9)	10,146.2	10,131.3	–	10,131.3	10,162.0	30.7	9,771.3
B. Child Trust Fund endowments	–	(8.5)	249.1	240.6	–	240.6	240.0	(0.6)	212.4
Total	–	(23.4)	10,395.3	10,371.9	–	10,371.9	10,402.0	30.1	9,983.7
Resource Outturn	**4,771.6**	**141.3**	**10,756.1**	**15,669.0**	**(639.6)**	**15,029.4**	**15,087.0**	**57.6**	**14,402.8**

**Certain prior year figures have been restated as per note 37.*

Explanation of the variances between Estimate and outturn for each Request for Resources

Request for resources 4, Payment of Local Authority Rates (POLAR) is underspent by £7.7m (20.9 per cent). This is a demand-led vote and therefore outturn depends on a number of factors which are difficult to forecast with precision.

Detailed explanations of the variances are given in the Management Commentary.

3. Reconciliation of outturn to net operating cost and against Administration Budget

3(a) Reconciliation of net resource outturn to net operating cost

				2006-07 £m	Restated* 2005-06 £m
	Note	Outturn	Supply Estimate	Outturn compared with Estimate	Outturn
Net Resource Outturn	2	15,029.4	15,087.0	57.6	14,402.8
Non-supply income (CFERs)	5	(24.2)	–	24.2	(4.4)
Non-supply expenditure	22	1.9	–	(1.9)	1.6
Net operating cost		**15,007.1**	**15,087.0**	**79.9**	**14,400.0**

3(b) Outturn against final Administration Budget

		2006-07 £m	Restated* 2005-06 £m
	Budget	Outturn	Outturn
Gross Administration Budget	4,805.0	4,771.5	4,624.0
Income allowable against the Administration Budget	(281.5)	(274.8)	(352.8)
Net outturn against final Administration Budget	**4,523.5**	**4,496.7**	**4,271.2**

**Certain prior year figures have been restated as per note 37.*

4. Reconciliation of resources to cash requirement

	Note	Estimate £m	Outturn £m	Net total outturn compared with estimate: savings/(excess) £m
Resource Outturn	2	15,087.0	15,029.4	57.6
Capital				
Acquisition of fixed assets		342.3	307.6	34.7
Non-operating A in A				
Proceeds of fixed asset disposals		(4.0)	(3.8)	(0.2)
Accruals adjustments				
Non-cash items	10, 11	(377.9)	(359.8)	(18.1)
Changes in working capital other than cash		179.9	116.9	63.0
Changes in creditors falling due after more than 1 year	20	–	(3.0)	3.0
Use of provisions	21	143.2	141.9	1.3
Excess cash receipts surrenderable to the Consolidated Fund	5	–	–	–
Net cash requirement		**15,370.5**	**15,229.2**	**141.3**

Explanation of the variances between Estimate and cash requirement

- The acquisition of fixed assets varied by £34.7m (10.1 per cent) from the Estimate. This was due to expenditure on IT software being lower than expected.
- Changes in working capital other than cash varied by £63.0m (35.0 per cent) from the Estimate. The balance of creditors and accruals did not reduce to the expected level.
- Changes in creditors falling due after more than one year varied by £3.0m from the Estimate. No separate estimate was made for this item and estimate provision was included in the working capital category.

5. Analysis of income payable to the Consolidated Fund

In addition to Appropriations in Aid, the following income relates to the Department and is payable to the Consolidated Fund (cash receipts being shown in italics).

		Forecast 2006-07		Outturn 2006-07	
			£m		£m
	Note	Income	Receipts	Income	Receipts
Operating income and receipts – excess A in A		–	–	(22.3)	*(22.3)*
Other operating income and receipts not classified as A in A		–	–	(1.9)	*(1.9)*
		–	–	(24.2)	*(24.2)*
Non-operating income and receipts – excess A in A	7	–	–	(2.3)	*(2.3)*
Other non-operating income and receipts not classified as A in A	8	–	–	–	–
Other amounts collectable on behalf of the Consolidated Fund		(230.0)	*(230.0)*	(295.8)	*(264.4)*
Excess cash surrenderable to Consolidated Fund	4	–	–	–	–
Total income payable to the Consolidated Fund		**(230.0)**	***(230.0)***	**(322.3)**	***(290.9)***

6. Reconciliation of income recorded within the Operating Cost Statement to operating income payable to the Consolidated Fund

	Note	2006-07	Restated* 2005-06
		£m	£m
Operating income	12	(648.0)	(708.1)
Adjustments for transactions between RfRs		(15.8)	(16.5)
Gross income		(663.8)	(724.6)
Income authorised to be appropriated in aid		(639.6)	(720.2)
Operating income payable to the Consolidated Fund	5	**(24.2)**	**(4.4)**

**Certain prior year figures have been restated as per note 37.*

7. Non-operating income – Excess A in A

	2006-07	2005-06
	£m	£m
Principal repayments of voted loans	–	–
Proceeds on disposal of fixed assets	(2.3)	–
Other	–	–
Non-operating income – excess A in A	**(2.3)**	**–**

8. Non-operating income not classified as A in A

Recent guidance from HM Treasury concerning the reporting of Consolidated Fund Extra Receipts requires Single European Authorisation (SEA) income to be reported as 'Other amounts collectable on behalf of the Consolidated Fund'. In 2005-06 this was reported as 'Other non-operating income and receipts not classified as A in A' (note 5 and note 8). In 2006-07 SEA income due to the Consolidated Fund was £18.8m compared to £14.4m (restated) in 2005-06.

9. Staff numbers and related costs

Staff costs comprise:

				Restated*
			2006-07	2005-06
			£m	£m
	Total[1]	Permanently employed staff	Others	Total
Wages and salaries	2,256.5	2,184.5	72.0	2,187.0
Social security costs	166.0	161.9	4.1	165.2
Other pension costs	420.1	409.5	10.6	399.8
Sub-total	**2,842.6**	**2,755.9**	**86.7**	**2,752.0**
Less recoveries in respect of outward secondments	(1.5)	(1.5)	–	(2.5)
Total net costs	**2,841.1**	**2,754.4**	**86.7**	**2,749.5**
Of which:				
Core Department	**2,701.8**	**2,616.1**	**85.7**	**2,600.0**

[1] *Staff consist entirely of officials*

The Department does not pay the salary of the Minister who has responsibility for HM Revenue & Customs (HMRC). This is paid out of central funds and can be found in the resource accounts of HM Treasury.

The Principal Civil Service Pension Scheme (PCSPS) is an unfunded multi-employer defined benefit scheme but HMRC is unable to identify its share of the underlying assets and liabilities. The scheme actuary valued the scheme as at 31 March 2003. You can find details in the resource accounts of the Cabinet Office: Civil Superannuation (www.civilservice-pensions.gov.uk).

For 2006-07, employer's contributions of £419,483,950 were payable to the PCSPS (2005-06: £399,098,131) at one of four rates in the range 17.1 per cent to 25.5 per cent of pensionable pay, based on salary bands (the rates in 2005-06 were between 16.2 per cent and 24.6 per cent). The scheme's Actuary reviews employer contributions every four years following a full scheme valuation. From 2007-08, the salary bands will be revised but the rates will remain the same. The contribution rates are set to meet the cost of the benefits accruing during 2006-07 to be paid when the member retires, and not the benefits paid during this period to existing pensioners.

Employees can opt to open a partnership pension account, a stakeholder pension with an employer contribution. Employer's contributions of £601,154 (2005-06: £572,513) were paid to one or more of a panel of three appointed stakeholder pension providers. Employer contributions are age-related and range from 3.0 to 12.5 per cent of pensionable pay. Employers also match employee contributions up to 3 per cent of pensionable pay. In addition, employer contributions of £45,506, 0.8 per cent (2005-06: £42,645, 0.8 per cent) of pensionable pay, were payable to the PCSPS to cover the cost of the future provision of lump sum benefits on death in service and ill-health retirement of these employees.

Contributions due to the partnership pension providers at the balance sheet date were nil. Contributions prepaid at that date were nil.

186 persons (2005-06: 239 persons) retired early on ill-health grounds; the total additional accrued pension liabilities in the year amounted to £258,531 (2005-06: £304,564).

Average number of persons employed

The average number of full-time equivalent persons employed during the year was as follows. These figures within the Consolidated Departmental Resource Accounts include those working in the Core Department and the Valuation Office Agency.

				Restated*
			2006-07	**2005-06**
			Number	**Number**
	Total	**Permanently employed staff**	**Others**	**Total**
RfR 1: Administration				
Objective 1	68,629	64,909	3,720	70,700
Objective 2	12,286	11,620	666	12,657
Objective 3	8,831	8,352	479	9,098
RfR 2: Valuation Office Agency	4,425	4,398	27	5,081
RfR 3: Payments in lieu of tax relief	2	2	0	2
RfR 4: Payments of Local Authority Rates	3	3	0	3
RfR 5: Child Benefit and Child Trust Fund	1,625	1,553	72	1,768
Total	**95,801**	**90,837**	**4,964**	**99,309**
Of which:				
Core Department	**91,373**	**86,436**	**4,937**	**94,225**

This analysis is approximate, because in practice many activities undertaken by the Department support more than one of the three Objectives within RfR 1. Prior year comparatives for Objectives 1-3 have been reapportioned using 2006-07 apportionments due to the change in methodology used to calculate the apportionments for 2006-07.

**Certain prior year figures have been restated as per note 37.*

10. Other Administration Costs

	Note	2006-07 £m Core Department		2006-07 £m Consolidated		Restated* 2005-06 £m Core Department		Restated* 2005-06 £m Consolidated	
Rentals under operating leases:									
Hire of plant and machinery		3.9		3.9		3.0		3.0	
Other operating leases		26.2		26.7		13.6		14.5	
			30.1		30.6		16.6		17.5
Interest charges:									
On-balance sheet PFI contracts		13.4		13.4		13.2		13.2	
			13.4		13.4		13.2		13.2
PFI service charges:									
Off-balance sheet contracts		245.3		259.8		394.2		408.5	
Service element of on-balance sheet contracts		4.0		4.0		3.8		3.8	
Indexation of liability on PFI deals		4.9		4.9		4.9		4.9	
			254.2		268.7		402.9		417.2
Non-cash items:									
Depreciation		166.9		172.4		127.7		134.0	
Amortisation		5.4		5.4		6.3		6.3	
Barter deal prepayments		14.1		14.3		21.5		21.7	
Profit on disposal of fixed assets		(4.2)		(4.2)		–		(0.2)	
Loss on disposal of fixed assets		1.7		1.7		17.2		17.2	
Net (profit)/loss on revaluation		–		–		5.6		5.6	
Cost of capital charges		26.9		27.6		18.4		19.0	
Auditor's remuneration and expenses[1]		1.9		1.9		1.9		1.9	
Amounts provided for liabilities and charges	21	0.9		1.8		15.3		18.7	
Amounts provided for early departure costs [2]	21	67.6		71.4		7.7		21.0	
Unwinding of early departure costs discounting	21	1.9		2.1		1.8		2.4	
			283.1		294.4		223.4		247.6

10. Other Administration Costs (continued)

					Restated*
			2006-07		2005-06
			£m		£m
	Note	Core Department	Consolidated	Core Department	Consolidated
Other expenditure:					
Travel, subsistence and hospitality		91.4	96.3	93.4	98.0
Accommodation expenses		138.1	147.1	127.7	137.5
Administrative staff related costs		3.3	3.3	3.6	3.6
Printing, postage, stationery and office supplies		113.2	115.0	124.6	127.1
Telephone expenses		59.5	60.8	19.2	20.9
IT services and consumables		645.4	653.8	496.1	503.7
Legal costs [3]		–	–	31.3	32.2
Consultancy [4]		80.5	81.0	63.5	65.3
Contracted out services		22.9	22.9	19.2	19.2
Publicity		17.6	17.6	30.3	30.3
Post Office services		22.5	22.5	35.4	35.4
Bank charges		18.9	18.9	17.4	17.4
Other miscellaneous expenditure		72.3	66.9	71.4	69.9
		1,285.6	1,306.1	1,133.1	1,160.5
Total		**1,866.4**	**1,913.2**	**1,789.2**	**1,856.0**

[1] These are notional amounts and there was no non-audit work.

[2] In 2006-07 the early departure costs provision was classified as administration expenditure. In 2005-06 this was shown as £21.0m under note 10 and £50.9m as 'Efficiency Challenge Fund provision' under note 11.

[3] In 2006-07 legal costs were classified as administration (note 10) or programme (note 11) expenditure. In 2005-06 most legal costs were classified as administration expenditure.

[4] Consultancy costs amounting to £8.4m (2005-06: £5.3m) have been capitalised as part of the cost of developing fixed assets. The total amount of consultancy expenditure for 2006-07 was £89.4m (2005-06: £106.3m, where in addition to the £65.3m reported as Consultancy, further amounts totalling £35.7m were reported within other expenditure headings).

**Certain prior year figures have been restated as per note 37.*

11. Programme costs

	Note	2006-07 £m Core Department	2006-07 £m Consolidated	Restated* 2005-06 £m Core Department	Restated* 2005-06 £m Consolidated
Child Benefit and Child Trust Fund					
Child Benefit		10,144.3	10,144.3	9,763.3	9,763.3
Child Benefit (Lone Parent) Premium		1.9	1.9	5.7	5.7
Guardians Allowance (Funded from NIF)		1.9	1.9	1.6	1.6
Child Trust Fund Endowments		176.4	176.4	162.7	162.7
		10,324.5	10,324.5	9,933.3	9,933.3
Payments in lieu of tax relief					
Life Assurance Premium Relief, MIRAS, Vocational Training		10.3	10.3	13.0	13.0
Transitional payments to charities		0.2	0.2	1.3	1.3
Supplement on payroll giving to charities		–	–	–	–
Stakeholder pensions		70.0	70.0	64.0	64.0
		80.5	80.5	78.3	78.3
Payments of Local Authority Rates					
Payments of Local Authority Rates (POLAR)		–	32.9	–	33.1
Less programme income		–	(4.1)	–	(4.2)
		–	28.8	–	28.9
Other Programme Costs					
Incentive Payments		278.3	278.3	225.2	225.2
Legal and investigation		67.2	67.2	57.2	57.2
Lorry Road User Charge		–	–	32.8	32.8
Bank charges via OPG		6.7	6.7	6.3	6.3
Other programme expenditure		43.8	43.8	14.1	14.1
Less programme income		(44.3)	(44.3)	(12.6)	(12.6)
		351.7	351.7	323.0	323.0
Non-cash items					
Depreciation of assets		8.5	8.5	15.3	15.3
Cost of capital charges		(23.4)	(23.4)	(19.1)	(19.1)
Profit/Loss on disposal of fixed assets		(0.1)	(0.1)	–	–
Provisions	21				
Child Trust Fund provision		72.7	72.7	72.0	72.0
POLAR provision		–	0.4	–	0.4
Efficiency Challenge Fund provision		–	–	50.9	50.9
Other programme provisions		7.3	7.3	1.0	1.0
		65.0	65.4	120.1	120.5
Total		**10,821.7**	**10,850.9**	**10,454.7**	**10,484.0**

**Certain prior year figures have been restated as per note 37.*

12. Income

Core Department	RfR 1	RfR 2	RfR 3	RfR 4	RfR 5	2006-07 £m Total	Restated* 2005-06 £m Total
Income from external customers	(77.7)	–	–	–	–	(77.7)	(57.1)
Income from other departments	(35.5)	–	–	–	–	(35.5)	(40.9)
Income from the National Insurance Fund	(338.7)	–	–	–	–	(338.7)	(354.5)
Other income	(0.6)	–	–	–	–	(0.6)	(31.2)
	(452.5)	**–**	**–**	**–**	**–**	**(452.5)**	**(483.7)**
Consolidated	**RfR 1**	**RfR 2**	**RfR 3**	**RfR 4**	**RfR 5**	**Total**	**Total**
Income from external customers	(74.6)	(19.2)	–	–	–	(93.8)	(77.2)
Income from other departments	(34.5)	(176.3)	–	–	–	(210.8)	(241.0)
Income from the National Insurance Fund	(338.7)	–	–	–	–	(338.7)	(354.5)
Other income	(0.6)	–	–	(4.1)	–	(4.7)	(35.4)
	(448.4)	**(195.5)**	**–**	**(4.1)**	**–**	**(648.0)**	**(708.1)**

Of total operating income received, the following relates to services provided to external and public sector customers where full cost exceeds £1.0m. In each case the financial objective is to recover the full costs of the service. This information is provided for fees and charges purposes, not to comply with SSAP 25.

			2006-07 £m			2005-06 £m
	Income	Full Cost	Surplus/ (deficit)	Income	Full Cost	Surplus/ (deficit)
Fees & Charges raised by the Valuation Office Agency (VOA)						
Rating & Council Tax	(176.6)	170.7	5.9	(204.1)	197.3	6.8
Other valuation work	(19.2)	19.8	(0.6)	(20.4)	22.7	(2.3)
Work on behalf of HMRC	(11.5)	11.5	–	(12.2)	12.8	(0.6)
Fees & Charges raised by the Core Department						
International Assistance	(2.5)	2.9	(0.4)	(2.4)	2.3	0.1
Money Service Businesses	(2.2)	3.2	(1.0)	(2.2)	2.8	(0.6)
Bank charges via OPG	(6.5)	6.7	(0.2)	(6.0)	6.5	(0.5)
National Minimum Wage	(5.7)	5.5	0.2	(5.8)	5.7	0.1
Collection of Student Loans	(4.4)	4.3	0.1	(3.3)	3.9	(0.6)
DWP Welfare Reform Agenda	(2.9)	3.3	(0.4)	(3.0)	3.0	–
DWP Office Services and Accounting	(4.1)	4.1	–	(5.8)	5.6	0.2
IT services provided to RCPO	(1.6)	1.6	–	(1.6)	1.6	–
Services provided to the Valuation Office Agency	(4.0)	4.1	(0.1)	(3.9)	3.9	–
Charges to the National Insurance Fund	(338.7)	304.3	34.4	(354.5)	360.6	(6.1)
Total	**(579.9)**	**542.0**	**37.9**	**(625.2)**	**628.7**	**(3.5)**

**Certain prior year figures have been restated as per note 37.*

13. Analysis of net operating cost by spending body

			Restated*
		2006-07	2005-06
		£m	£m
Spending body:	**Estimate**	**Outturn**	**Outturn**
Core Department	15,050.1	14,983.2	14,374.6
Valuation Office Agency	36.9	23.9	25.4
Net Operating Cost	**15,087.0**	**15,007.1**	**14,400.0**

**Certain prior year figures have been restated as per note 37.*

14. Tangible fixed assets

	Freehold Land & Buildings[2]	Accommodation refurbishments[2]	Office & Computer Equipment	Vehicles	Furniture & Fittings[3]	Developed Computer Software	Assets under construction	Vessels	Scientific Aids	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Cost or valuation										
At 1 April 2006[1]*	95.1	136.6	231.6	30.0	121.7	1,088.9	270.5	30.3	65.2	2,069.9
Adjustments	–	–	–	–	–	–	–	–	–	–
Additions	–	0.6	26.9	2.2	3.4	4.5	266.4	–	1.0	305.0
Donations	–	–	–	–	–	–	–	–	–	–
Disposals	(2.5)	(1.9)	(34.1)	(3.1)	(7.6)	(9.1)	–	(0.4)	(6.7)	(65.4)
Reclassifications	–	20.3	(1.5)	(0.6)	1.2	290.9	(311.9)	–	1.6	–
Revaluations[4]	–	(0.4)	14.0	–	(0.7)	(46.4)	–	–	(2.3)	(35.8)
At 31 March 2007	**92.6**	**155.2**	**236.9**	**28.5**	**118.0**	**1,328.8**	**225.0**	**29.9**	**58.8**	**2,273.7**
Depreciation										
At 1 April 2006[1]*	(1.2)	(63.3)	(137.2)	(19.2)	(64.4)	(539.9)	–	(9.7)	(38.9)	(873.8)
Adjustments	–	–	–	–	–	–	–	–	–	–
Charged in year	(1.5)	(10.3)	(50.3)	(3.8)	(5.6)	(100.9)	–	(1.5)	(7.0)	(180.9)
Disposals	0.8	1.0	33.5	3.0	7.4	9.1	–	0.3	6.7	61.8
Reclassifications	–	(0.1)	0.3	0.6	–	–	–	–	(0.8)	–
Revaluations[4]	–	(0.4)	(6.8)	–	0.7	20.1	–	–	2.5	16.1
At 31 March 2007	(1.9)	(73.1)	(160.5)	(19.4)	(61.9)	(611.6)	–	(10.9)	(37.5)	(976.8)
Net Book Value at 31 March 2007	**90.7**	**82.1**	**76.4**	**9.1**	**56.1**	**717.2**	**225.0**	**19.0**	**21.3**	**1,296.9**
Net Book Value at 31 March 2006	**93.9**	**73.3**	**94.4**	**10.8**	**57.3**	**549.0**	**270.5**	**20.6**	**26.3**	**1,196.1**
Asset financing:										
Owned	23.1	82.1	76.4	9.1	56.1	717.2	225.0	19.0	21.3	1,229.3
Finance leased	–	–	–	–	–	–	–	–	–	–
On-balance sheet PFI contracts	67.6	–	–	–	–	–	–	–	–	67.6
PFI residual interests	–	–	–	–	–	–	–	–	–	–
Net Book Value at 31 March 2007	**90.7**	**82.1**	**76.4**	**9.1**	**56.1**	**717.2**	**225.0**	**19.0**	**21.3**	**1,296.9**
Analysis of tangible fixed assets										
The net book value of tangible fixed assets comprises:										
Core Department at 31 March 2007	90.7	81.3	75.8	9.1	54.4	693.1	218.9	19.0	21.3	1,263.6
Valuation Office Agency at 31 March 2007	–	0.8	0.6	–	1.7	24.1	6.1	–	–	33.3
Core Department at 31 March 2006	93.9	72.5	92.9	10.8	55.0	525.9	270.5	20.6	26.3	1,168.4
Valuation Office Agency at 31 March 2006	–	0.8	1.5	–	2.3	23.1	–	–	–	27.7

[1] *Assets have been reviewed upon the implementation of the new ERP financial system and this has resulted in certain prior year balances being reclassified.*

[2] *See note 1.3.2 for the accounting policy for property assets.*

[3] *See note 1.3.3 for the accounting policy for furniture.*

[4] *See notes 1.1 and 1.3 for the accounting policy regarding revaluation of fixed assets.*

**Certain prior year figures have been restated as per note 37.*

Freehold Land and building 100 Parliament Street

The accounting treatment adopted by HM Revenue & Customs is consistent with that of HM Treasury in respect of our joint arrangement for the land and building on the site. A valuation was undertaken by the Valuation Office Agency in November 2005 at £92.6m. This was an interim valuation without inspection, the last full valuation was performed in November 2004.

15. Intangible fixed assets

The Department's intangible fixed assets comprise purchased software licences.

	Total £m
Cost or valuation	
At 1 April 2006	24.9
Adjustments	–
Additions	2.6
Donations	–
Disposals	–
Reclassifications	–
Revaluation[1]	–
At 31 March 2007	**27.5**
Amortisation	
At 1 April 2006	(13.9)
Charged in year	(5.4)
Disposals	–
Reclassifications	–
Revaluation[1]	–
At 31 March 2007	**(19.3)**
Net book value at 31 March 2007	**8.2**
Net book value at 31 March 2006	**11.0**

Analysis of intangible fixed assets

The net book value of intangible fixed assets comprises:

Core Department at 31 March 2007	8.2
Valuation Office Agency at 31 March 2007	–
Core Department at 31 March 2006	11.0
Valuation Office Agency at 31 March 2006	–

[1] *See notes 1.1 and 1.3 for the accounting policy regarding revaluation of fixed assets.*

16. Investments

The Department has no financial investments.

17. Stocks and work in progress

		2006-07 £m		2005-06 £m
	Core Department	Consolidated	Core Department	Consolidated
Stocks	8.1	8.1	0.7	0.7
Work in progress	0.3	3.6	0.5	3.4
	8.4	**11.7**	**1.2**	**4.1**

18. Debtors

18(a) Analysis by type

		2006-07 £m		Restated* 2005-06 £m
	Core Department	Consolidated	Core Department	Consolidated
Amounts falling due within one year:				
Trade debtors	–	6.6	0.4	7.7
Deposits and advances	19.3	17.5	24.6	24.5
Value added tax	43.6	43.6	26.8	26.8
Other debtors – excluding Child Benefit and CTF	28.3	29.9	23.2	23.8
Other debtors – Child Benefit and CTF	20.1	20.1	19.8	19.8
Prepayments and accrued income – excluding Child Benefit and CTF	28.5	29.8	24.8	26.3
Prepayments and accrued income – Child Benefit and CTF	12.5	12.5	23.4	23.4
Barter deals	14.5	14.7	13.7	13.9
Penalties	267.7	267.7	230.5	230.5
Amounts due from the Consolidated Fund in respect of supply	–	–	–	–
	434.5	**442.4**	**387.2**	**396.7**
Amounts falling due after more than one year:				
Trade debtors	–	–	–	–
Deposits and advances	–	–	–	–
Other debtors	0.5	0.5	0.6	0.6
Prepayments and accrued income	–	0.1	–	–
Barter deals	177.0	179.0	191.9	194.1
	177.5	**179.6**	**192.5**	**194.7**

18(b) Intra-Government Balances

	Amounts falling due within one year		Amounts falling due after more than one year	
	£m		£m	
	2006-07	2005-06	2006-07	2005-06
Balances with other central government bodies	63.7	53.4	–	0.1
Balances with local authorities	1.8	5.8	–	–
Balances with NHS Trusts	1.5	1.8	–	–
Balances with public corporations and trading funds	0.1	–	–	–
Subtotal: intra-government balances	67.1	61.0	–	0.1
Balances with bodies external to government	375.3	335.7	179.6	194.6
Total debtors at 31 March	**442.4**	**396.7**	**179.6**	**194.7**

CFER penalties not yet collected from taxpayers are reported as a debtor in the balance sheet, matched by a corresponding creditor to the Consolidated Fund (see note 20). Within this note they are included in the balance related to 'Penalties'.

**Certain prior year figures have been restated as per note 37.*

19. Cash at bank and in hand

	2006-07		2005-06	
	£m		£m	
	Core Department	Consolidated	Core Department	Consolidated
Balance 1 April	35.3	47.2	78.1	89.4
Net change in cash balances	39.9	36.5	(42.8)	(42.2)
Balance at 31 March	**75.2**	**83.7**	**35.3**	**47.2**
The following balances at 31 March were held at:				
Office of HM Paymaster General	15.1	23.6	13.4	25.3
Commercial banks and cash in hand	60.1	60.1	21.9	21.9
Balance at 31 March	**75.2**	**83.7**	**35.3**	**47.2**

20. Creditors

20(a) Analysis by type

				Restated*
		2006-07		2005-06
		£m		£m
	Core Department	Consolidated	Core Department	Consolidated
Amounts falling due within one year:				
Taxation and social security	(51.5)	(51.5)	(49.2)	(49.4)
Trade creditors	(153.6)	(152.5)	(220.1)	(220.4)
Other creditors – excluding Child Benefit and CTF	(6.0)	(7.0)	(21.2)	(24.9)
Other creditors – Child Benefit and CTF	(169.3)	(169.3)	(306.6)	(306.6)
Accruals and deferred income – excluding Child Benefit and CTF	(217.9)	(223.5)	(124.4)	(127.8)
Accruals and deferred income – Child Benefit and CTF	(189.8)	(189.8)	(172.5)	(172.5)
Finance leases	–	–	–	–
Current part of imputed finance lease element of on-balance sheet PFI contracts	(1.9)	(1.9)	(1.7)	(1.7)
Amounts issued from the Consolidated Fund for supply but not spent at year end	(17.9)	(16.9)	(31.2)	(39.0)
Consolidated Fund Extra Receipts due to be paid to the Consolidated Fund				
received	(57.3)	(66.8)	(4.1)	(8.2)
receivable	(253.0)	(253.0)	(214.2)	(214.2)
	(1,118.2)	**(1,132.2)**	**(1,145.2)**	**(1,164.7)**
Amounts falling due after more than one year:				
Finance leases	–	–	–	–
Imputed finance lease element of on-balance sheet PFI contracts	(188.6)	(188.6)	(185.6)	(185.6)
	(188.6)	**(188.6)**	**(185.6)**	**(185.6)**

20(b) Intra-Government Balances

	Amounts falling due within one year £m		Amounts falling due after more than one year £m	
	2006-07	2005-06	2006-07	2005-06
Balances with other central government bodies	(417.4)	(343.4)	–	–
Balances with local authorities	(1.1)	(0.4)	–	–
Balances with NHS Trusts	–	(0.1)	–	–
Balances with public corporations and trading funds	–	–	–	–
Subtotal: intra-government balances	(418.5)	(343.9)	–	–
Balances with bodies external to government	(713.7)	(820.8)	(188.6)	(185.6)
Total creditors at 31 March	**(1,132.2)**	**(1,164.7)**	**(188.6)**	**(185.6)**

CFER penalties not yet collected from taxpayers are reported as a debtor in the balance sheet (see note 18), matched by a corresponding creditor. Within this note they are included in the balance 'Consolidated Fund Extra Receipts due to be paid to the Consolidated Fund: receivable'.

**Certain prior year figures have been restated as per note 37.*

21. Provisions for liabilities and charges

Core Department	Early Departure Costs £m	Child Trust Fund £m	Legal Claims £m	Accommodation Costs £m	Other £m	Total £m
Balance at 1 April 2006[1]	(90.3)	(93.6)	(14.8)	(4.5)	(17.2)	(220.4)
Provided in the year	(67.6)	(80.3)	(7.0)	(1.3)	(5.7)	(161.9)
Provisions not required written back	–	7.6	3.1	0.8	1.9	13.4
Provisions utilised in the year	41.7	80.0	5.3	3.1	2.0	132.1
Unwinding of discount	(1.9)	–	–	–	–	(1.9)
Balance at 31 March 2007	**(118.1)**	**(86.3)**	**(13.4)**	**(1.9)**	**(19.0)**	**(238.7)**
Consolidated						
Balance at 1 April 2006[1]	(108.2)	(93.6)	(18.9)	(5.9)	(17.5)	(244.1)
Provided in the year	(71.5)	(80.3)	(9.6)	(1.3)	(6.1)	(168.8)
Provisions not required written back	0.1	7.6	4.0	1.6	1.9	15.2
Provisions utilised in the year	50.5	80.0	5.5	3.7	2.2	141.9
Unwinding of discount	(2.1)	–	–	–	–	(2.1)
Balance at 31 March 2007	**(131.2)**	**(86.3)**	**(19.0)**	**(1.9)**	**(19.5)**	**(257.9)**

[1] Certain prior year figures have been restated as per note 37.

21.1 Early Departure Costs

The Department meets the additional costs of benefits beyond the normal PCSPS benefits in respect of employees who retire early by paying the required amounts annually to the PCSPS over the period between early departure and normal retirement date. The Department provides for this in full when the early retirement programme becomes binding by establishing a provision for the estimated payments discounted by HM Treasury discount rate of 2.2 per cent in real terms. In past years the Department paid in advance some of its liability for early retirement by making a payment to the Paymaster General's Account at the Bank of England for the credit of the Civil Service Superannuation Vote. The balance remaining is treated as a prepayment.

21.2 Child Trust Fund

The Child Trust Fund Act (2004) established tax-free savings and investment accounts for eligible children born on or after 1 September 2002. The Government makes payments into a Child Trust Fund account for each eligible child, enabling the accumulation of assets to be made available upon attaining the age of 18. A provision of £86.3m has been included in the 2006-07 Resource Accounts as at 31 March 2007 for amounts that will become payable in respect of children born up to 31 March 2007 (2005-06: £93.6m). This provision includes £69.0m (2005-06: £64.9m) for supplementary endowments expected to be payable in respect of children in families where the family income is below the income threshold for Child Tax Credit purposes.

21.3 Legal Claims

A provision of £19.0m (2005-06: £18.9m) has been made for costs relating to various legal claims against the Department. The provision reflects all known claims where legal advice indicates that it is probable that the claim will be successful and the amount of the claim can be reliably estimated. Legal claims which may succeed but are less likely to do so or cannot be estimated reliably are disclosed as contingent liabilities in note 31.

21.4 Accommodation Costs

A provision of £1.9m has been made (2005-06: £5.9m) mainly for buildings-related claims giving rise to probable liabilities under tenancy agreements where the amount of the claims can be reliably estimated. Claims, which may succeed but are less likely to do so or cannot be estimated reliably are disclosed as contingent liabilities in note 31.

21.5 Other

Other provisions have been made for the following:

- Provisions of £17.0m (2005-06: £12.9m) have been made in respect of Shipbuilders Relief.
- Provisions relating to various other claims against the Department amount to £2.5m (2005-06: £4.6m).

22. General Fund

The General Fund represents the total assets less liabilities of each of the entities within the accounting boundary, to the extent that the total is not represented by other reserves and financing items.

					Restated*
			2006-07		2005-06
			£m		£m
	Note	Core Department	Consolidated	Core Department	Consolidated
Balance at 1 April		72.6	81.7	(192.7)	(179.2)
Prior period adjustment		4.6	4.6	–	–
Adjusted opening balance		77.2	86.3	(192.7)	(179.2)
Net Parliamentary funding					
Drawn down		15,177.0	15,207.0	14,727.9	14,754.5
Deemed		31.2	39.0	54.3	59.6
Transferred from/to HMRC in respect of transferred functions SOCA/OPG	37	–	–	(116.7)	(116.7)
Net financing from the Contingencies Fund		–	–	–	–
National Insurance Fund		1.9	1.9	1.6	1.6
Year end adjustment					
Supply creditor/(debtor) – current year		(17.9)	(16.9)	(31.2)	(39.0)
Excess vote – prior year		–	–	–	–
Net transfer from operating activities					
Net operating cost		(14,983.2)	(15,007.1)	(14,374.6)	(14,400.0)
CFERs repayable to Consolidated Fund		(21.2)	(26.5)	(0.6)	(4.4)
Non-cash charges					
Cost of capital		3.5	4.2	(0.7)	(0.1)
Auditors' remuneration		1.9	1.9	1.9	1.9
Transfer from revaluation reserve		–	–	3.4	3.5
Balance at 31 March		**270.4**	**289.8**	**72.6**	**81.7**

**Certain prior year figures have been restated as per note 37.*

23. Reserves

Revaluation Reserve

The revaluation reserve reflects the unrealised element of the cumulative balance of indexation and revaluation adjustments (excluding donated assets).

	2006-07 £m Core Department	2006-07 £m Consolidated	2005-06 £m Core Department	2005-06 £m Consolidated
Balance at 1 April	171.8	173.7	105.1	106.2
Arising on revaluation during the year (net)	(20.3)	(19.7)	70.1	71.0
Transferred to General Fund in respect of realised element of revaluation reserve	–	–	(3.4)	(3.5)
Balance at 31 March	**151.5**	**154.0**	**171.8**	**173.7**

24. Notes to the Consolidated Cash Flow Statement

24(a) Reconciliation of operating cost to operating cash flows

	Note	2006-07 £m	Restated* 2005-06 £m
Net operating cost	13	15,007.1	14,400.0
Adjustments for non-cash transactions	10, 11	(359.8)	(368.1)
Increase/(Decrease) in Stock and work in progress	17	7.6	0.1
Increase/(Decrease) in Debtors	18	30.6	(43.6)
less movements in debtors relating to items not passing through the OCS		(24.4)	40.6
(Increase)/Decrease in Creditors	20	24.8	86.7
less movements in creditors relating to items not passing through the OCS		78.5	(57.9)
Use of provisions	21	141.9	252.2
Net cash outflow from operating activities		**14,906.3**	**14,310.0**

24(b) Analysis of capital expenditure and financial investment

	Note	2006-07 £m	2005-06 £m
Tangible fixed asset additions	14	305.0	384.5
Intangible fixed asset additions	15	2.6	0.5
Finance lease acquisitions		–	–
Proceeds of disposal of fixed assets		(3.8)	(0.7)
Net cash outflow from investing activities		**303.8**	**384.3**

24(c) Analysis of capital expenditure and financial investment by Request for Resources

	Capital expenditure £m	Loans etc. £m	A in A £m	Net total £m
RfR 1: Administration	297.0	–	(3.8)	293.2
RfR 2: Valuation Office Agency	10.6	–	–	10.6
RfR 3: Payments in lieu of tax relief	–	–	–	–
RfR 4: Payments of Local Authority Rates	–	–	–	–
RfR 5: Child Benefit and Child Trust Fund	–	–	–	–
Total 2006-07	**307.6**	**–**	**(3.8)**	**303.8**
Total 2005-06	**385.0**	**–**	**(0.7)**	**384.3**

24(d) Analysis of financing

	Note	2006-07 £m	2005-06 £m
From the Consolidated Fund (Supply) – current year	22	15,207.0	14,754.5
From the Consolidated Fund (Supply) – prior year		–	–
From the National Insurance Fund	22	1.9	1.6
Payments to the National Insurance Fund		–	–
Advances from the Contingencies Fund		–	–
Repayments to the Contingencies Fund		–	–
Capital element of payments in respect of finance leases and on-balance sheet PFI contracts		3.2	3.3
Transferred from/to HMRC in respect of transferred functions SOCA/OPG		–	(81.2)
Net financing		**15,212.1**	**14,678.2**

24(e) Reconciliation of Net Cash Requirement to increase/(decrease) in cash

	Note	2006-07 £m	2005-06 £m
Net cash requirement		(15,229.2)	(14,775.1)
From the Consolidated Fund (Supply) – current year	24(d)	15,207.0	14,754.5
From the Consolidated Fund (Supply) – prior year	24(d)	–	–
Amounts due to the Consolidated Fund received in a prior year and paid over		(4.1)	(29.8)
Amounts due to the Consolidated Fund received and not paid over		62.8	8.2
Increase/(decrease) in cash		**36.5**	**(42.2)**

**Certain prior year figures have been restated as per note 37.*

25. Notes to the Consolidated Statement of Operating Costs by Departmental Aim and Objectives

Programme grants and other current expenditures have been allocated as follows:

	2006-07	Restated* 2005-06
	£m	£m
RfR 1: Administration		
Objective 1	347.6	352.6
Objective 2	11.5	22.4
Objective 3	8.3	16.1
RfR 2: Valuation Office Agency	–	–
RfR 3: Payments in lieu of tax relief	80.5	78.3
RfR 4: Payments of Local Authority Rates	29.2	29.3
RfR 5: Child Benefit and Child Trust Fund	10,373.8	9,985.3
Total	**10,850.9**	**10,484.0**

The capital employed by the Department is allocated by analysis of the underlying assets and liabilities attributable to each Request for Resources (RfR). A framework of operational and support activities is used to apportion the objectives within RfR 1.

Capital Employed by Departmental Aim and Objectives at 31 March 2007

	2006-07	Restated* 2005-06
	£m	£m
RfR 1: Administration		
Objective 1	638.4	591.8
Objective 2	114.3	105.9
Objective 3	82.1	76.2
RfR 2: Valuation Office Agency	22.6	13.8
RfR 3: Payments in lieu of tax relief	–	–
RfR 4: Payments of Local Authority Rates	(0.7)	(2.8)
RfR 5: Child Benefit and Child Trust Fund	(412.9)	(529.5)
Total	**443.8**	**255.4**

This analysis is approximate, because in practice many activities undertaken by the Department support more than one of the three objectives within RfR 1. Prior year comparatives for Objectives 1-3 have been reapportioned using 2006-07 apportionments due to the change in methodology used to calculate the apportionments for 2006-07.

**Certain prior year figures have been restated as per note 37.*

26. Capital commitments

	2006-07 £m Core Department	2006-07 £m Consolidated	2005-06 £m Core Department	2005-06 £m Consolidated
Contracted capital commitments at 31 March 2007 for which no provision has been made	31.6	32.8	141.9	142.0

27. Commitments under leases

27.1 Operating leases

Commitments under operating leases to pay rentals during the year following the year of these accounts are given in the table below, analysed according to the period in which the lease expires.

	2006-07 £m Core Department	2006-07 £m Consolidated	2005-06 £m Core Department	2005-06 £m Consolidated
Obligations under operating leases comprise:				
Land and buildings:				
Expiry within 1 year	15.0	15.2	–	1.7
Expiry after 1 year but not more than 5 years	–	2.8	–	1.2
Expiry thereafter	235.0	252.8	234.0	251.6
	250.0	**270.8**	**234.0**	**254.5**
Other:				
Expiry within 1 year	0.8	0.9	0.7	0.9
Expiry after 1 year but not more than 5 years	4.3	4.5	2.6	2.8
Expiry thereafter	480.9	490.9	482.0	490.9
	486.0	**496.3**	**485.3**	**494.6**

27.2 Finance leases

Obligations under finance leases are as follows.

	2006-07 £m Core Department	2006-07 £m Consolidated	2005-06[1] £m Core Department	2005-06[1] £m Consolidated
Obligations under finance leases comprise:				
Rentals due within 1 year	–	–	–	–
Rentals due after 1 year but within 5 years	–	–	–	–
Rentals due thereafter	–	–	–	–
	–	–	–	–
Less interest element	–	–	–	–
	–	**–**	**–**	**–**

[1] *The balances previously reported relate to 100 Parliament Street. As an imputed finance lease these are now only disclosed at notes 28.2 and 28.3.*

28. Commitments under PFI contracts

28.1 Off-balance sheet

The following assets are not the property of the Department.

Description of Scheme	Estimated Capital Value[1] £m	Contract Start Date	Contract End Date
Trinity Bridge House, Manchester – Serviced office accommodation	32	September 1998	September 2013
Elgin House, Edinburgh – Serviced office accommodation	10	November 1998	November 2013
Cotton House, Glasgow – Serviced office accommodation	10	December 1998	December 2013
Archer House, Stockport – Serviced office accommodation	6	May 1999	May 2014
Strategic Transfer Estate to Private Sector – Serviced office accommodation	370	April 2001	March 2021
St John's House, Bootle – Serviced office accommodation	12	May 2000	May 2025
Newcastle Estate Development	88	October 1999	August 2027
Newcastle Estate Development with DWP (NEDFAR)	27	October 2004	October 2029

[1] *The estimated capital value is as at commencement of the schemes.*

28.2 On-balance sheet

The following asset is treated as an asset of the Department under FRS 5. The asset is the provision of serviced accommodation at 100 Parliament Street (see note 14). The substance of the contract is that payments comprise two elements – imputed finance lease charges and service charges. Details of the imputed finance lease charges are in the following table.

	2006-07 £m		2005-06 £m	
	Core Department	Consolidated	Core Department	Consolidated
Imputed finance lease obligations under on-balance sheet PFI contracts comprises:				
Rentals due within 1 year	15.7	15.7	15.2	15.2
Rentals due within 2 to 5 years	67.1	67.1	64.9	64.9
Rentals due thereafter	657.4	657.4	669.8	669.8
	740.2	740.2	749.9	749.9
Less interest element	(549.7)	(549.7)	(562.6)	(562.6)
	190.5	**190.5**	**187.3**	**187.3**

28.3 Charge to the Operating Cost Statement and future commitments

The total amount charged in the Operating Cost Statement in respect of off-balance sheet PFI transactions and the service element of on-balance sheet PFI transactions was £274.6m (2005-06: £428.6m) and the payments to which the Department is committed during 2007-08, analysed by the period during which the commitment expires, is as follows.

		2006-07		2005-06
		£m		£m
	Core Department	Consolidated	Core Department	Consolidated
Expiry within 1 year	–	–	–	–
Expiry within 2 to 5 years	–	–	–	–
Expiry within 6 to 10 years	11.6	11.6	11.5	11.5
Expiry within 11 to 15 years	203.3	219.9	203.0	219.2
Expiry within 16 to 20 years	2.6	2.6	2.5	2.5
Expiry within 21 to 25 years	17.5	17.5	17.0	17.0
Expiry within 26 to 30 years	–	–	–	–
Expiry within 31 to 35 years	4.0	4.0	3.9	3.9

29. Other financial commitments

The Department has entered into non-cancellable contracts (which are not leases or PFI contracts) for various services. The payments to which the Department is committed during 2007-08, analysed by the period which the commitment expires are as follows.

		2006-07		2005-06
		£m		£m
	Core Department	Consolidated	Core Department	Consolidated
Expiry within 1 year	2.0	2.0	–	–
Expiry within 2 to 5 years	30.3	30.3	11.3	11.3
Expiry thereafter	–	–	–	–
	32.3	**32.3**	**11.3**	**11.3**

30. Financial instruments

The Department has very limited powers to borrow or invest surplus funds and except for relatively insignificant forward purchases of foreign currency, financial assets and liabilities are generated by day to day operational activities and are not held to change the risks facing the Department in undertaking its activities. Due to the largely non-trading nature of its activities and the way in which Government departments are financed, the Department is not exposed to the degree of financial risk faced by business entities.

31. Contingent liabilities disclosed under FRS 12

At 31 March 2007 contingent liabilities existed in respect of:

- Shipbuilders Relief – a contingent liability of £101.6m (2005-06: £97.9m) exists for various claims against the Department.
- Annual Leave Compensation – a contingent liability of £0.5m (2005-06: £21.0m) exists for compensation that may become payable depending on the outcome of a legal case that has been appealed to the European Court of Justice. The substantially reduced contingency is due to a re-assessment of the numbers of employees involved.
- Legal Claims – a contingent liability of £26.4m (2005-06: £20.2m) exists for costs that may be awarded should various legal cases in which HMRC is involved be determined against the Department. The contingent liability covers all such cases where the outcome is unknown or cannot be estimated reliably.
- Property Dilapidation – the Department has a small number of contingent liabilities relating to lease termination.
- The Department has a further number of contingent liabilities amounting to £5.4m (2005-06: £4.3m).

32. Contingent liabilities not required to be disclosed under FRS 12 but included for parliamentary reporting and accountability purposes

32.1 Quantifiable

The Department has entered into quantifiable contingent liabilities by offering 79 (2005-06: 70) indemnities to the value of £2.0m (2005-06: £0.9m). None of these is a contingent liability within the meaning of FRS 12 since the likelihood of a transfer of economic benefit in settlement is too remote. The Department has not entered into any guarantees or letters of comfort.

32.2 Unquantifiable

The Department has not entered into any unquantifiable contingent liabilities by offering guarantees, indemnities or by giving letters of comfort.

33. Losses and special payments

33(a) Losses Statement

		2006-07		2005-06
	cases	£m	cases	£m
Losses are made up of:				
Child Benefit irrecoverable overpayments	*58,776*	16.8	*58,332*	10.2
Law costs remissions	*71,716*	8.0	*90,964*	8.3
Tax penalty remissions	*28,386*	12.1	*35,859*	14.0
Others	*1,029*	1.2	*7,160*	8.3
Total	***159,907***	**38.1**	***192,315***	**40.8**

Details of cases over £250,000

£0.5m – A scheme for pre-funding the Paymaster General's Office, to meet future early departure pension costs existed prior to 2000-01. During 2006-07 the pre-funding previously made has exceeded the expenditure met by the Paymaster General's Office.

33(b) Special Payments

	2006-07		2005-06	
	Cases	£m	Cases	£m
Payments and Accruals	*21,517*	7.7	*49,200*	19.1
New Provisions	*6*	0.5	*5*	2.2
Write back of Provisions		(0.6)		(0.5)
Total	***21,523***	**7.6**	***49,205***	**20.8**

Details of cases over £250,000

£1.1m – The sum of ex-gratia payments made to small employers in respect of e-filing payments.

£1.0m – Ex-gratia payment in respect of stock losses caused by control and enforcement action.

£0.8m – Ex-gratia payments in respect of delayed payments of Age Related Rebates arising from the late processing of electronically submitted pension forms.

HMRC receives two types of penalty income: Appropriations in Aid (A in A) penalties that can be applied to fund operational activities and Consolidated Fund Extra Receipts (CFER) penalties that the Department must surrender direct to the Exchequer. A in A penalties are recorded within the Operating Cost Statement (OCS) and any related remissions appear within the losses note above. CFER penalties are recorded within note 5 to the accounts. They are not related to operating activities so are not proper to the OCS and the related losses do not appear within the body of this note. The Department wrote-off £107.9m of CFER fines and penalties in 2006-07, the majority as a result of trader/taxpayer insolvency.

34. Related-party transactions

The Department is the parent of the Valuation Office Agency. This body is regarded as a related-party with which the Department has had various material transactions during the year.

The Valuation Office Agency has had a significant number of material transactions with other government departments. Most of these transactions have been with Communities and Local Government and the Welsh Assembly Government.

In addition, the Department has had a small number of transactions with other government departments and other central government bodies.

No Board member, key manager or other related parties has undertaken any material transactions with the Department during the year.

35. Third-party assets

These are not Departmental assets and are not included in the accounts.

35.1 EU Funds

The Department holds Euro deposits in relation to European Commission (EC) Twinning Projects. For such projects it is common for the lead body to hold Euro funds on behalf of the EC. The funds are payable to other European Union (EU) member states as reimbursement for work undertaken in assisting EU candidate states in preparing for membership of the EU. The Department holds these funds as an agent of the EC. Neither the Department nor the Government generally have any beneficial interest in these funds, which are separately held at the Bank of England.

35.2 Seized monies and other assets

The Department manages Sterling and US dollar interest-bearing accounts at the Bank of England containing seized monies. The Department also holds cash and other significant assets retained as physical evidence in connection with ongoing legal proceedings. These assets are held as part of the Department's law enforcement activities and as such do not form part of these accounts. Once legal proceedings have been completed any seized cash is either forfeited to the Home Office, confiscated by the court or, if the defendant is found not guilty, returned.

Where seized assets are forfeited to HMRC without legal proceedings, proceeds from the sale are paid to the Exchequer as CFER within 'Other amounts collectable on behalf of the Consolidated Fund' (note 5).

The assets held at the balance sheet date to which it was practical to ascribe monetary values comprised:

		31 March 2006	Gross inflows	Gross outflows	31 March 2007
Monies on deposit at the Bank of England					
Euro deposits	€	0.7m	1.9m	2.1m	0.5m
Sterling deposits	£	18.1m	16.1m	18.6m	15.6m
US Dollar deposits	$	1.0m	–	–	1.0m

Other significant assets held at the balance sheet date to which it was not practical to ascribe monetary value comprised:

	31 March 2006	31 March 2007
	Number	Number
Motor vehicles	1,257	1,493
Vessels	3	4

36. Entities within the departmental boundary

The entities within the boundary during 2006-07 were as follows:

- Supply-financed agencies: Valuation Office Agency
- Non-departmental public bodies: None
- Others: None

The Annual Report and Accounts of the Valuation Office Agency are published separately and can be viewed at www.voa.gov.uk.

37. HM Revenue & Customs – Transfer of functions

With effect from April 2006, responsibility for serious organised crime within HMRC transferred to the Serious Organised Crime Agency (SOCA). This transfer of function has resulted in 1,127 full-time equivalent posts being transferred to SOCA.

With effect from April 2006, responsibility for the Office of the Paymaster General (OPG) transferred from HM Treasury to HMRC. This transfer of function has resulted in 8 full-time equivalent posts being transferred to HMRC.

The transfers have been accounted for as a business combination using merger accounting principles in accordance with HM Treasury resource accounting requirements. Accordingly, the results and cash flows relating to the transferred services have been brought to account from the start of the financial year. Prior-year comparative figures have been restated.

The share of the operating cost for the year attributable to the transferred functions was £89.6m. The share of the balance sheet at 31 March 2006 attributable to the transferred functions was £28.2m.

Restatement of Operating Cost Statement at 31 March 2006

	Published accounts at 31 March 2006 £m	Function transferred SOCA £m	Function transferred OPG £m	Restated at 31 March 2006 £m
Net administration costs	3,997.6	(81.9)	0.3	3,916.0
Net programme costs	10,492.0	(8.2)	0.2	10,484.0
Net operating cost	**14,489.6**	**(90.1)**	**0.5**	**14,400.0**
Restatement of Balance Sheet at 31 March 2006				
Net Assets as at 31 March 2006	**283.6**	**(28.2)**	**–**	**255.4**

38. Post balance sheet events

There are no reportable post balance sheet events. The financial statements were authorised for issue by the Principal Accounting Officer on 10 July 2007.

Accounts Direction given by HM Treasury in accordance with Section 5 (2) of the Government Resources and Accounts Act 2000

The accounts direction given by HM Treasury in accordance with section 5 (2) of the Government Resources and Accounts Act 2000, covering both the Resource Accounts and the Trust Statement is shown on pages 104 to 105.

Trust Statement

Contents	**Page**

Principal Accounting Officer's Foreword to the Trust Statement

Scope

HM Revenue & Customs (HMRC) is a non-Ministerial Government Department. It is responsible for collecting direct and indirect taxes, making payments of tax credits and child benefit, collecting repayments of student loans, enforcing payment of the national minimum wage and enforcing Government requirements relating to the movement of goods across the UK national and the EU common frontier. The Trust Statement reports the revenues and expenditures and assets and liabilities related to the taxes and duties for the financial year 2006-07 and reports the full year's activity of HMRC. The costs of running HMRC, and payments of Child Benefit and Child Trust Fund, are reported in the Departmental Resource Accounts.

The taxes and duties for which HMRC has accounted for in this Trust Statement are:

- Income, Corporation, Capital Gains, Inheritance, Insurance Premium, Stamp and Petroleum Revenue taxes
- Value Added Tax (VAT)
- Excise duties
- Customs duties
- Environmental taxes: climate change levy, aggregates levy and landfill tax
- National Insurance Contributions (NICs)
- Tax Credits and
- Recovery of Student Loan repayments

RN Ltd, a Nominee Company registered in 1933, was set up to hold taxpayers' assets as security for outstanding taxes and liabilities. These assets do not belong to the Department and are not included within the Trust Statement.

The general direction and priorities for HMRC were set out in the remit letter issued to the Chairman by the Chancellor of the Exchequer on 7 April 2005. HMRC's aim and objectives are stated in the Annual Report to the Resource Accounts, which also provide details of its Management, and includes a Management Commentary.

Financial Review

During the year, the total Revenue accruing to the Department is £436.9 billion, an increase of £31.7 billion (+7.8 per cent) on last year. This is mainly due to an increase in Income Tax and NICs receipts and to a lesser extent VAT, Corporation Tax and Stamps.

Revenue from Income Tax & NICs accounted for 55 per cent of the total. It was £14.6 billion (+6.5 per cent) higher than in 2005-06 primarily due to increases in wages and salaries. Higher bonus related payments and reduced contracting out from the State Second Pension scheme are believed also to have boosted receipts.

VAT revenue accounted for 20 per cent of the total. It was £11.7 billion (+15.9 per cent) higher than in 2005-06. Most of this increase is due to HMRC's refusal of suspected missing trader intra-community (MTIC) fraud claims and the success of HMRC's operational strategy, in reducing the value of attempted MTIC. VAT receipts have also grown in line with growth in consumer's expenditure. Some of the increase is also attributable to a rise in bad and doubtful debt, the majority from MTIC traders, which is written off later in the accounts.

Revenue for Corporation Tax accounted for 10 per cent of the total. It was £1.9 billion (+4.6 per cent) higher than in 2005-06 mainly due to higher receipts from the banking, industrial and commercial sectors partly offset by lower receipts from the North Sea and life assurance sectors.

Revenue for Stamp Taxes accounted for 3 per cent of the total. It was £2.7 billion (+24.3 per cent) higher than in 2005-06. Most of this increase was due to higher stamp duty land tax revenue, mainly caused by higher property prices and transaction volumes.

The remaining taxes accounted for 12 per cent of the total and increased by £0.8 billion (+1.5 per cent) on last year.

Total Revenue losses increased by £1.4 billion (+43.4 per cent), primarily due to an increase in write-offs of £1.4 billion (+48 per cent).

In particular VAT write-offs increased by £1.4 billion (+96.3 per cent) mainly due to two factors – a very large increase in the value of missing trader intra-community fraud losses and a special exercise that was undertaken to clear aged irrecoverable debt.

Provision for Doubtful Debt increased by £1.4 billion (+27.5 per cent), mainly fuelled by a significant increase (£1.7 billion) in the level of outstanding missing trader intra-community fraud debt at 31 March 2007.

Basis for the Preparation of the Trust Statement

The HM Treasury accounts direction, issued under Section 2 of the Exchequer and Audit Departments Act 1921, requires HMRC to prepare the Trust Statement to give a true and fair view of the state of affairs relating to the collection and allocations of taxes and duties and the revenue income and expenditure and cash flows for the financial year. Regard shall be given to all relevant accounting and disclosure requirements given in *Government Accounting* and other guidance issued by HM Treasury and the principles underlying UK Generally Accepted Accounting Practice (UK GAAP).

HMRC has worked closely with HM Treasury to ensure that the accounting policies that underpin these accounts are comprehensive, appropriate, and supported to a sufficient level of detail by reports from Departmental business systems.

Owing to the diverse nature of the taxes and duties administered by HMRC, a variety of methods are used to produce the relevant accruals information.

Selection of Appropriate Accounting Policies for the Trust Statement and Use of Judgements and Estimates

As Principal Accounting Officer, it is my responsibility to apply suitable accounting policies in the preparation of the Trust Statement. The underlying approach to accruals measurement is that revenues from taxation are deemed to accrue evenly over the (tax return) period for which they are due. Revenues are recognised in the period in which the event that generates the revenue occurs.

In respect of the direct taxes, the nature of tax legislation and our associated systems, some of the accrued revenue receivable figures and some other items are subject to statistical estimation or forecasts. We have used estimates for a number of taxation streams because the majority of tax returns reporting taxpayer liabilities are not required to be sent to us until several months after the Trust Statement has been published.

In preparing our estimates we have to take account of areas of uncertainty around those factors which determine future revenue flows. We therefore have to make complex judgements concerning some of these factors and we have procedures in place to do this.

We use statistical models to derive the estimates. These are based on a combination of projections based on the most recent revenue flows and forecasts of economic variables on which future revenue flows depend. We have based these forecasts on what we believe to be the relevant inputs. However, because of the areas of uncertainty involved, there will inevitably be differences between our forecasts and future outturns. These differences arise because of the need to make judgements on areas of uncertainty and are not indicative of deficiencies in our models. We believe that the levels of variation are acceptable with a maximum likely overall uncertainty expected to be some £4 billion, which does not significantly affect the reported position. This figure is equivalent to less than 1 per cent of total revenue reported in the Statement of Revenue and Expenditure.

This maximum likely overall uncertainty is based on a combination of evidence from the performance of the models over five years and the judgement of professional departmental economists and statisticians having substantial experience of forecasting in the area of direct taxes.

The accuracy of the estimates included in the 2005-06 Trust Statement has been reviewed as more recent data has become available, and I can confirm that they were within the levels of overall uncertainty quoted there.

Accrued revenue receivable is separately estimated for each revenue stream and component of income tax. The main economic assumptions which have been used are based on those which were, in part, set out in Parts B and C of the Chancellor of the Exchequer's March 2006 Financial Statement and Budget Report. The most important assumption in this context is that profits from self-employment are assumed to rise by 4.6 per cent in 2006-07.

Accrued revenue receivable and accrued revenue liabilities are estimated for VAT, as the amounts involved are material. Estimation techniques are not required for other indirect taxes and duties where actual data is available.

No tax collection system can ensure that all those who have a tax liability comply with their obligations. Whilst the Department is concerned with compliance, the Trust Statement does not show the estimates of taxes foregone as a result of avoidance and non-compliance with taxpayers' obligations.

Auditors

The Trust Statement is audited by the Comptroller and Auditor General under Section 2 of the Exchequer and Audit Departments Act 1921. The auditor's notional remuneration for this is included in HMRC's Resource Accounts.

No non-audit work was carried out by the auditors for HMRC.

Paul Gray
Principal Accounting Officer
3 July 2007

Statement of the Principal Accounting Officer's Responsibilities in Respect of the Trust Statement

HM Treasury has appointed the Permanent Head of Department as Principal Accounting Officer of HMRC with overall responsibility for preparing the Trust Statement and for transmitting it to the Comptroller and Auditor General.

The Principal Accounting Officer for HMRC is responsible for ensuring that there is a high standard of financial management, including a sound system of internal control; that financial systems and procedures promote the efficient and economical conduct of business and safeguard financial propriety and regularity; that financial considerations are fully taken into account in decisions on policy proposals; and that risk is considered in relation to assessing value for money.

The Principal Accounting Officer is responsible for the fair and efficient administration of the tax system, including the assessment, collection and proper allocation of revenue, and payment of tax credits and other entitlements.

Under section 2(3) of the Exchequer and Audit Departments Act 1921, the Principal Accounting Officer is responsible for the preparation and submission to the Comptroller and Auditor General of a Trust Statement for HMRC for the financial year 2006-07. In conforming with HM Treasury direction (see page 104 of this Trust Statement), the Trust Statement reports the revenue collected and expenditure in respect of taxes, duties, National Insurance Contributions, tax credits and Student Loan recoveries administered by HMRC during the year, together with the net amounts surrendered to the Consolidated Fund.

The Trust Statement is prepared on an accruals basis, except for Corporation Tax for small companies, Stamp Duty and National Insurance Classes 1A, 1B and 3, which are accounted for on a cash basis. The Trust Statement must give a true and fair view of the state of affairs of HMRC, including a Statement of Revenue and Expenditure, a Balance Sheet, and a Cash Flow Statement.

The Trust Statement includes a Statement on Internal Control (SIC), which sets out the governance risk and control arrangements for HMRC. The SIC process is firmly and clearly linked to the risk management process in HMRC.

In preparing the Trust Statement, the Principal Accounting Officer is required to:

- observe the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;
- make judgements and estimates on a reasonable basis;
- state whether applicable accounting standards have been followed and disclose and explain any material departures in the account.

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which an Accounting Officer is answerable, for keeping proper records and for safeguarding the Department's assets, are set out in the Accounting Officers' Memorandum issued by HM Treasury and published in *Government Accounting*.

Statement on Internal Control

The Department's Statement on Internal Control, covering both the Resource Accounts and the Trust Statement, is shown on pages 1 to 8.

The Certificate of the Comptroller and Auditor General to the House of Commons

I certify that I have audited Her Majesty's Revenue and Customs Trust Statement for the year ended 31 March 2007 under the Exchequer and Audit Departments Act 1921, as amended by the Government Resources and Accounts Act 2000. The Trust Statement comprises the Statement of Revenue and Expenditure, the Balance Sheet, the Cash Flow Statement and the related notes. The Trust Statement has been prepared under the accounting policies set out within the notes to the Statement.

Respective responsibilities of the Principal Accounting Officer and auditor

The Principal Accounting Officer is responsible for preparing the Trust Statement in accordance with the Exchequer and Audit Departments Act 1921, as amended by the Government Resources and Accounts Act 2000 and HM Treasury directions made thereunder, and for ensuring the regularity of financial transactions. These responsibilities are set out in the Statement of Principal Accounting Officer's Responsibilities.

My responsibility is to audit the Trust Statement in accordance with relevant legal and regulatory requirements, including section 2(3) of the Exchequer and Audit Departments Act 1921, as amended by the Government Resources and Accounts Act 2000 and with International Standards on Auditing (UK and Ireland).

I report to you my opinion as to whether the Trust Statement gives a true and fair view and has been properly prepared in accordance with HM Treasury directions issued under the Exchequer and Audit Departments Act 1921, as amended by the Government Resources and Accounts Act 2000. I also report whether in all material respects the revenue and expenditure have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

In addition, I also report to you if the Department has not kept proper accounting records or if I have not received all the information and explanations I require for my audit.

I review whether the Statement on Internal Control, on pages 1 to 8, reflects the Department's compliance with HM Treasury's guidance, and I report if it does not. In forming an audit opinion on the Trust Statement, I am not required to consider whether the Principal Accounting Officer's Statement on Internal Control covers all risks and controls, or to form an opinion on the effectiveness of the Department's corporate governance procedures or its risk and control procedures.

I read the other information contained in the Principal Accounting Officer's Foreword to the Trust Statement and consider whether it is consistent with the audited financial statements. I consider the implications for my opinion if I become aware of any apparent misstatements or material inconsistencies with the Trust Statement. My responsibilities do not extend to any other information.

Basis of audit opinions

I conducted my audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. My audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of financial transactions included in the Trust Statement. It also includes an assessment of the significant estimates and judgements made by the Principal Accounting Officer in the preparation of the Trust Statement, and of whether the accounting policies are most appropriate to the Department's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the Trust Statement is free from material misstatement, whether caused by fraud or error, and that in all material respects the revenue and expenditure have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinions

Audit opinion

In my opinion:

- the Trust Statement gives a true and fair view, in accordance with the Exchequer and Audit Departments Act 1921, as amended by the Government Resources and Accounts Act 2000 and directions made thereunder by HM Treasury, of the state of affairs as at 31 March 2007 relating to the collection and allocation of taxes, duties, national insurance contributions, tax credits and student loan recoveries and related expenditures administered by the Department, and cash flows for the year then ended;
- the Trust Statement has been properly prepared in accordance with HM Treasury directions issued under the Exchequer and Audit Departments Act 1921, as amended by the Government Resources and Accounts Act 2000.

Emphasis of Matter: significant uncertainty in the estimates of accrued revenue receivable and accrued revenue liabilities

In forming my opinion, which is not qualified, I have considered the adequacy of the disclosures made in Notes 6 and 7 to the Trust Statement of the estimates of accrued tax revenue receivable of £80.6 billion and accrued revenue liabilities of £25.0 billion at 31 March 2007. As described in Note 6.1.4, the Department considers that the combined accrued revenue receivable and accrued revenue liabilities at 31 March 2007 are subject to maximum likely uncertainty of £4 billion in either direction, equivalent to less than one per cent of total revenue reported in the Statement of Revenue and Expenditure. The significant uncertainty is adequately disclosed in the Trust Statement.

Qualified opinion on regularity: tax credit payments not applied to the purposes intended by Parliament

As shown in Note 3.3 to the Trust Statement, Her Majesty's Revenue and Customs estimates that for 2004-05 claimant error and fraud accounted for incorrect payments of tax credits in claimants favour of between £1.04 billion and £1.30 billion (7.3 per cent to 9.1 per cent of finalised entitlement). The Department currently has no estimate of the total level of claimant error and fraud in the tax credit awards made since 2004-05. Whilst the Department has made changes to its compliance procedures since 2004-05 there is currently no evidence to demonstrate a lower estimate for claimant error and fraud for 2006-07. Accordingly, I have been unable to confirm that, in all material respects, these payments are in conformity with the authorities which govern them and have been applied for the purposes intended by Parliament. I have therefore qualified my audit opinion on the regularity of tax credit payments in the Trust Statement in this respect.

Except for the probable level of error leading to significant amounts of tax credits not being paid to claimants in accordance with entitlement referred to above, in all material respects the revenue and expenditure have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

Report

Please see my Report at Pages 82 to 84 on these matters.

John Bourn
Comptroller and Auditor General
6 July 2007

National Audit Office
157-197 Buckingham Palace Road
Victoria, London SW1W 9SP

The maintenance and integrity of the HM Revenue and Customs' website is the responsibility of the Accounting Officer; the work carried out by the auditors does not involve consideration of these matters and accordingly the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

HM Revenue and Customs 2006-07 Trust Statement
Report by the Comptroller and Auditor General

Introduction

1. The HM Revenue and Customs (HMRC) Trust Statement records the total taxes and duties collected and receivable as a result of earning taxable income, profits or gains from other taxable transactions. It also records certain disbursements and expenditure, notably the national insurance contributions collected by the Department on behalf of the National Insurance Funds and National Health Services, and expenditure on tax credits.
2. In 2006-07, some £344.9 billion (2005-06: £314.1 billion) was collectable by the Department in tax revenues, against total expenditure of £21.9 billion (2005-06: £16.1 billion). Other revenue of £92.0 billion (2005-06: £91.1 billion), principally £91.5 billion of national insurance contributions was also collectable. Disbursements totalling £91.8 billion primarily comprised £91.1 billion of national insurance contributions paid over to the National Insurance Funds and the National Health Services.
3. As recorded in Note 3.1 to the Trust Statement, the Department incurred £17.9 billion (2005-06: £16.0 billion) of expenditure on tax credits awards in 2006-07. In accordance with the Organisation for Economic Co-operation and Development's classification rules, tax credit expenditure is presented in the Trust Statement as negative taxation to the extent that the tax credits are less than or equal to the recipient family's income tax liability and as payments of entitlement where tax credits exceed the recipient family's income tax liability. In 2006-07 tax credit expenditure comprised £4.4 billion classified as negative taxation and £13.5 billion classified as payments of entitlement.

Audit opinion on the truth and fairness of the Trust Statement

4. I am required, under Auditing Standards, to obtain sufficient evidence to satisfy myself that Her Majesty's Revenue and Customs Trust Statement gives a true and fair view and has been properly prepared in accordance with Treasury Directions issued under the Exchequer and Audit Departments Act 1921 as amended by the Government Resources and Accounts Act 2000. In forming my opinion, I examine, on a test basis, evidence supporting the amounts, disclosures and regularity of financial transactions included in the financial statements and assess the significant estimates and judgements made in preparing them.

Qualified opinion on regularity: tax credit payment have not been applied to the purposes intended by Parliament

My responsibilities with regard to regularity

5. I am required, under the Exchequer and Audit Departments Act 1921, as amended by the Government Resources and Accounts Act 2000, to form an opinion on whether, in all material respects, the revenue and expenditure have been applied to the purposes intended by Parliament and conform to the authorities which govern them.

The legal framework

6. The Tax Credits Act 2002 and statutory instruments made thereunder form the regulatory framework for tax credits. This framework prescribes the entitlement of individuals to claim Child Tax Credit and Working Tax Credit and the determination of the awards in accordance with the individual's circumstances. Tax credit payments may be made in error where claimants incorrectly or fraudulently disclose their circumstances in their application.

Claimant error and fraud

7. As stated in Note 3.3, HMRC establishes its overall measure of the level of claimant error and fraud by investigating a random sample of tax credit awards. Regulations and procedure established under Section 19 of the Tax Credits Act 2002 only allow the Department to begin its enquiries into randomly selected awards after the awards have been finalised; that is, after claimants have confirmed their income and circumstances for the year of the award. While most awards for 2004-05 were finalised by the end of September 2005, some claimants such as those taxpayers included within Self Assessment, may not have finalised their awards for 2004-05 until January 2006. The Department could not therefore start its investigation of the finalised awards for 2004-05 until February 2006.

8. In June 2007, the Department completed its testing of 2004-05 tax credit awards, based on a sample of some 4,500 random enquiries against claimant records. As a result of this testing, it estimated that claimant error and fraud led to between £1.04 billion and £1.30 billion (7.3 per cent to 9.1 per cent of the final award by value) being paid to claimants to which they were not entitled. These levels of claimant error and fraud are unacceptably high.

9. Whilst the Department has made changes to its compliance procedures since 2004-05, there is currently no evidence to demonstrate a lower estimate of claimant fraud and error in the tax credit awards for 2006-07, compared to 2004-05.

10. Tax credit payments made in relation to awards or those aspects of awards for which there is no entitlement under the Tax Credits Act 2002 and the regulations made thereunder, whether due to claimant error or fraud, are by definition without proper authority. Accordingly I have concluded that the payments arising from erroneous and fraudulent tax credit claims are not in conformity with the authorities which govern them and have not been applied to the purposes intended by Parliament. I have therefore qualified my opinion on the regularity of income and expenditure on the Department's Trust Statement for 2006-07 because of the probable levels of claimant error and fraud in the payment of tax credits.

Emphasis of matter: Significant uncertainty in the estimates of accrued revenue receivable and accrued revenue liabilities

11. As stated in Note 6.1 to the Trust Statement, the Department has provided estimates to support the accrued revenue receivable balances and accrued revenue liability balances where tax returns reporting taxpayer liabilities are not filed until after the Trust Statement has been published.

12. The Trust Statement records accrued tax revenue receivable of £80.6 billion at 31 March 2007, as shown in Note 6. This figure represents amounts not yet due or received from taxpayers, but relating to the financial year (or for certain corporation tax liabilities to an earlier financial year) where these have not been included in debtors. It comprises separate estimates of accrued revenue receivable balances for income tax collected under PAYE, self assessment, company income tax and tax deducted from savings income, corporation tax, value added tax, petroleum revenue tax, stamp duty land tax and stamp duty reserve tax, and national insurance contributions. The Department estimates these figures using statistical models for each component tax stream.

13. The Trust Statement also records some £25.0 billion in respect of accrued revenue liabilities at 31 March 2007, as shown in Note 7. This includes value added tax liabilities and amounts due to National Insurance Funds and National Health Services in respect of national insurance contributions. The Department also estimates these figures using statistical models.

14. Note 6 to the Trust Statement describes the estimation techniques and details of the underlying assumptions used by HMRC in arriving at the estimate of accrued revenue receivable for corporation tax, self assessment income tax and Class 4 national insurance contributions, and value added tax. Similar descriptions have not been provided for those tax streams where the estimated monetary amounts are either relatively small or not deemed to be particularly sensitive to changes in the underlying assumptions.

15. As described in Note 6.1.4, HMRC considers, because of the areas of uncertainty involved, there will inevitably be differences between the forecasts and future outturns. These differences arise because of the need to make judgements on areas of uncertainty and are not indicative of deficiencies in the models. The Department believes that the levels of variation are acceptable with a maximum likely overall uncertainty expected to be some £4 billion. This figure is equivalent to less than one per cent of total Revenue reported in the Statement of Revenue and Expenditure.

16. My audit of the estimates for accrued revenue receivable and accrued revenue liabilities involved: gaining an understanding of each of the models used to support the estimates; assessing the appropriateness and validity of the inputs used for each model; testing the calculations involved in the estimate, including the calculation of the overall uncertainty of the estimates; reviewing subsequent events to confirm the reasonableness of the estimates; and assessing management's review and approval procedures. In forming my opinion, I have considered the adequacy of the disclosures made in Notes 6 and 7 to the Trust Statement of the estimates of accrued tax revenue receivable and accrued revenue liabilities at 31 March 2007.

17. I am satisfied that the significant uncertainty in the estimates of accrued revenue receivable and accrued revenue liabilities is adequately disclosed in the Trust Statement and my opinion is not qualified in respect of this matter.

Conclusion

18. Except for the tax credit payments affected by claimant error and fraud, I am satisfied that, in all material respects, the revenue and expenditure recorded in the Trust Statement has been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. I am also satisfied that the Trust Statement gives a true and fair view of Her Majesty's Revenue and Customs' affairs as at 31 March 2007 in respect of taxes, duties, national insurance contributions, tax credits and student loan recoveries and related expenditures administered by the Department, and the revenue income and expenditure and cash flows for the year then ended.

John Bourn
Comptroller and Auditor General
6 July 2007

National Audit Office
157-197 Buckingham Palace Road
Victoria, London SW1W 9SP

Statement of Revenue and Expenditure for the year ended 31 March 2007

	Notes	2006-07 £ billion	2005-06 £ billion
Taxes and Duties			
Income Tax		148.8	134.8
Value Added Tax	2.1	85.5	73.8
Corporation Tax	2.2	43.3	41.4
Hydrocarbon Oils Duties		23.6	23.5
Alcohol Duties		8.0	7.9
Stamp Taxes	2.3	13.8	11.1
Tobacco Duties		7.6	8.4
Other Taxes and Duties	2.4	18.7	17.3
Tax Credits treated as Negative Taxation	3.1	(4.4)	(4.1)
Total Taxes and Duties		**344.9**	314.1
Other Revenue			
National Insurance Contributions	4.1	91.5	90.9
Student Loan Recoveries	4.3	0.5	0.2
Total Other Revenue		**92.0**	91.1
Total Revenue		**436.9**	405.2
Less Expenditure			
Tax Credits treated as Payments of Entitlement	3.1	(13.5)	(11.9)
Bad and Doubtful Debts	8.1	(6.2)	(4.3)
Provision for Liabilities	9	(2.2)	0.1
Total Expenditure		**(21.9)**	(16.1)
Less Disbursements			
National Insurance Contributions due to the National Insurance Funds and National Health Services	4.1	(91.1)	(90.5)
Student Loan Recoveries due to the Department for Education and Skills	4.3	(0.5)	(0.2)
Taxation Revenue due to the Isle of Man	5	(0.2)	(0.4)
Total Disbursements		**(91.8)**	(91.1)
Total Expenditure and Disbursements		**(113.7)**	(107.2)
Net Revenue for the Consolidated Fund		**323.2**	298.0

There were no recognised gains or losses accounted for outside the above Statement of Revenue and Expenditure.

The notes at pages 88 to 103 form part of this Statement.

Balance Sheet as at 31 March 2007

	Notes	31 March 2007 £ billion	31 March 2006 £ billion
Debtors falling due after more than one year	6	**2.8**	2.5
Current Assets			
Debtors	6	15.3	14.3
Accrued Revenue Receivable	6	80.6	75.9
		95.9	90.2
Current Liabilities			
Creditors	7	15.1	13.8
Accrued Revenue Liabilities	7	25.0	24.9
Deferred Revenue	7	0.6	0.5
Cash at Bank and in Hand		0.5	–
		41.2	39.2
Net Current Assets		**54.7**	51.0
Total Assets less Current Liabilities		**57.5**	53.5
Provision for Liabilities	9	**2.2**	**–**
Total Net Assets		**55.3**	53.5
Represented by:			
Balance on Consolidated Fund Account	10	**55.3**	53.5

The notes at pages 88 to 103 form part of this Statement.

Paul Gray
Principal Accounting Officer
3 July 2007

Cash Flow Statement for the year ended 31 March 2007

	Notes	2006-07 £ billion	2005-06 £ billion
Net Cash Flow from Revenue Activities	A	320.9	299.3
Cash paid to Consolidated Fund		(321.4)	(299.5)
Decrease in Cash in this period	B	**(0.5)**	(0.2)

Notes to the Cash Flow Statement

A: Reconciliation of Net Cash Flow to movement in Net Funds

	2006-07 £ billion	2005-06 £ billion
Net revenue for the Consolidated Fund	323.2	298.0
Increase in Non-cash Assets	(6.0)	(6.8)
Increase in Liabilities	1.5	8.2
Increase/(Decrease) in Provision for Liabilities	2.2	(0.1)
Net Cash Flow from Revenue Activities	**320.9**	299.3

B: Analysis of Changes in Net Funds

	2006-07 £ billion	2005-06 £ billion
Decrease in Cash in this period	(0.5)	(0.2)
Net Funds as at 1 April (Opening Cash at Bank)	–	0.2
Net Funds as at 31 March (Closing Cash at Bank)	**(0.5)**	0.0

The notes at pages 88 to 103 form part of this Statement.

Notes to the Trust Statement

1 Statement of Accounting Policies

1.1 Basis of Accounting

The Trust Statement is prepared in accordance with the accounts direction issued by HM Treasury under the Exchequer and Audit Departments Act 1921. The Trust Statement is prepared in accordance with the accounting policies detailed below. These have been developed by HM Revenue & Customs (HMRC) in consultation with HM Treasury, and with reference to UK GAAP and other relevant guidance. The accounting policies have been applied consistently in dealing with items considered material in relation to the accounts.

The financial information presented in the primary statements is rounded to the nearest £0.1 billion. The financial information presented in the notes to the financial statements is rounded to the nearest £0.1 billion except for Certificates of Tax Deposit, Student Loan Recoveries, tax revenue due to the Isle of Man, revenue losses and provision for liabilities, which are rounded to the nearest £ million.

1.2 Accounting Convention

The Trust Statement has been prepared in accordance with the historical cost convention. Taxes and duties are accounted for on an accruals basis, except for Corporation Tax for small companies, Stamp Duty and National Insurance Classes 1A, 1B and 3, which are accounted for on a cash basis.

1.3 Revenue Recognition

Taxes and Duties Recognised on an Accruals Basis

Taxes and duties are measured at the fair value of the consideration received or receivable net of repayments. Revenue is recognised when: a taxable event has occurred, the revenue can be measured reliably and it is probable that the economic benefits from the taxable event will flow to HMRC.

Taxable events for the material tax streams are as follows:

- Income Tax – earning of assessable income during the taxation period by the taxpayer
- Value Added Tax – undertaking of taxable activity during the taxation period by the taxpayer
- Corporation Tax – earning of assessable profit during the taxation period by the taxpayer
- Excise duties – movement of goods out of a duty suspended warehouse
- Hydrocarbon Oils Duty – production of taxable goods
- Stamp Taxes – purchase of property or shares
- Inheritance Tax – the date of agreement of assessment, after death or other chargeable transfer of value
- Capital Gains Tax – disposal of a chargeable asset leading to a taxable gain.

Revenues are deemed to accrue evenly over the period for which they are due. No revenue is recognised if there are significant uncertainties regarding recovery of the taxes and duties due.

Repayments of indirect taxes, for example VAT and Hydrocarbon Oils, are accounted for on an accruals basis.

Taxes Recognised on a Cash Basis

Taxes are recognised in the accounting period in which the tax receipt is received and are measured at the cash amount received.

Repayments of direct taxes, such as Income Tax and Corporation Tax, are recognised in the year the repayment is made.

Tax Credits

Tax credits are recognised in the year in which they are assessed and authorised by HMRC. Authorisation is the point at which the obligation to pay the tax credit arises.

Tax credits are presented as Negative Taxation to the extent that the tax credits are less than or equal to the recipient family's income tax liability and as Payments of Entitlement where tax credits exceed the recipient family's income tax liability. This is consistent with the Organisation for Economic Co-operation and Development's classification rules and international practice for the calculation of net taxes and social security contributions.

Payments of tax credits are provisional until entitlement is finalised after the financial year end. Under-payments are accounted for on a cash basis in the year of payment. Over-payments are recovered from future tax credit awards or through repayments by claimants.

National Insurance Contributions

National Insurance Contributions are collected by HMRC on behalf of the National Insurance Funds of Great Britain and Northern Ireland, and the Health Services for England, Wales, Scotland and Northern Ireland. They are payable to the Funds and the Health Services when received. Payments are based on estimates of NIC receipts received by HMRC. Differences between estimated receipts paid over and actual receipts are corrected in the following month and at the balance sheet date are recognised as a creditor or debtor as appropriate. Amounts due from taxpayers to HMRC but not received at the balance sheet date are included as accrued revenue liability in respect of the Funds and Health Services.

Student Loan Recoveries

HMRC collects Student Loans that are recovered through the taxes system on behalf of the Department for Education and Skills (DfES). Student Loan recoveries are accounted for on a cash basis. Amounts due at the year end are estimated on the basis of the end of year employer returns. Differences between estimated and actual recoveries are accounted for prospectively.

1.4 Debtors

Debtors are shown net of a provision for doubtful debts.

1.5 Provisions and Contingent Liabilities

Provisions for legal claims are recognised when HMRC has a present legal or constructive obligation as a result of a past event, it is probable that HMRC will be required to settle that obligation and an amount has been reliably estimated.

Amounts are disclosed as contingent liabilities where it is probable that HMRC will be required to settle the obligation and is unable to reliably estimate the amount, or where it is possible that HMRC will be required to settle the obligation.

2 Taxes and Duties Due

2.1 Value Added Tax

	2006-07	2005-06
	£ billion	£ billion
Gross VAT receipts	144.5	134.4
Less: Repayments	(59.0)	(60.6)
Net VAT receipts	**85.5**	73.8

VAT is structured in such a manner that companies are also entitled to claim repayments; hence a breakdown of gross receipts and repayments is disclosed.

2.2 Corporation Tax

The Corporation Tax revenue of £43.3 billion (2005-06: £41.4 billion) is net of Land Remediation Relief, and Research and Development Tax Credits. The estimated figures for the payable elements of these credits are £10 million (2005-06: £5 million) for Land Remediation Relief and £170 million (2005-06: £225 million) for Research and Development.

2.3 Stamp Taxes

	2006-07	2005-06
	£ billion	£ billion
Stamp Duty Land Tax	10.0	7.7
Stamp Duty Reserve Tax	3.2	2.9
Stamp Duty	0.6	0.5
	13.8	11.1

2.4 Other Taxes and Duties

	Note	2006-07	2005-06
		£ billion	£ billion
Inheritance Tax		3.7	3.3
Capital Gains Tax		3.9	3.2
Insurance Premium Tax		2.4	2.4
Petroleum Revenue Tax		2.1	2.0
Customs Duties		1.9	1.9
Betting And Gaming Duties		1.4	1.4
Air Passenger Duty		1.1	0.9
Landfill Tax	2.5	0.8	0.8
Climate Change Levy		0.7	0.7
Agricultural Duties		0.4	0.4
Aggregates Levy		0.3	0.3
Total Revenue Due		**18.7**	17.3

2.5 Landfill Tax

The Landfill Tax revenue of £828 million (2005-06: £756 million) is that receivable after a reduction of £52.5 million (2005-06: £45.6 million) has been made for contributions made to environmental bodies by landfill operators, under the Landfill Tax Credit Scheme.

3 Tax Credits

3.1 Analysis of Tax Credit Expenditure:

	Child Tax Credits 2006-07	**Working Tax Credits 2006-07**	**Total Tax Credits 2006-07**	**Child Tax Credits 2005-06**	**Working Tax Credits 2005-06**	**Total Tax Credits 2005-06**
	£ billion	£ billion	£ billion	£ billion	£ billion	£ billion
Tax Credits treated as Negative Taxation	2.8	1.6	4.4	2.7	1.4	4.1
Tax Credits treated as Payments of Entitlement	8.9	4.6	13.5	7.9	4.0	11.9
Total Tax Credits	**11.7**	**6.2**	**17.9**	10.6	5.4	16.0

Tax credit payments via Employers have been withdrawn from the 2006-07 tax year, (2005-06: £1,260 million). The division of amounts between Child and Working Tax Credits is based on estimates. Note 1.3 provides an explanation of Negative Tax and Payments of Entitlement.

3.2 Tax Credit Debtors

	Note	**2006-07**	**2005-06**
		£ billion	£ billion
Debtors as at 1 April	6	3.6	2.6
2004-05 Finalisation Overpayments		0.1	0.9
2005-06 Finalisation Overpayments		0.7	–
Overpayments identified from change of circumstances in year		0.6	1.0
Organised fraud		0.1	0.1
Recoveries made		(0.8)	(0.6)
Remissions/Write-offs	8.2	(0.4)	(0.4)
Debtors as at 31 March	6	**3.9**	3.6
Provision for doubtful debts		(1.6)	(1.4)
Net		**2.3**	2.2

Further overpayments relating to tax credits paid in 2003-04 and 2004-05, totalling £58 million, were identified during 2006-07. In addition, overpayments relating to tax credits paid in 2005-06 totalling £740 million were identified during 2006-07 as a result of the finalisation exercise undertaken in 2006-07. These have been accounted for in 2006-07.

In accordance with the accounting policy for tax credits (Note 1.3), amounts under or over paid in 2006-07 that are identified during the finalisation exercise undertaken in 2007-08 are not included in the above figures. The values of under and over payments arising from the 2006-07 finalisation exercise are estimated to be in the same order as those from the 2005-06 exercise.

Remissions and write-offs in 2006-07 include £40 million written off in respect of organised fraud identified during the year, and £186 million in respect of the suspended overpayments worklist (Note 8.3 refers).

3.3 Tax Credits Error and Fraud

HMRC measures the overall level of error and fraud by investigating a random sample of finalised awards, although the design of the tax credits scheme affects the speed with which it can complete this work. Some claimants, such as those taxpayers included with Self Assessment, may not finalise their awards for the preceding year until 31 January. HMRC may not therefore be able to start its investigation of some 2004-05 award cases until February 2006.

In June 2007, HMRC completed its testing of 2004-05 awards, based on a sample of some 4,500 random enquiries. As a result of this, HMRC estimates that claimant error and fraud resulted in £1.04 billion to £1.30 billion (7.3 to 9.1 per cent by value) being paid to claimants to which they were not entitled. It also estimates that claimant error resulted in £0.20 billion to £0.35 billion (1.4 to 2.4 per cent by value) not being paid to claimants to which they were entitled.

3.4 The Cost of Managing and Paying Tax Credits

As required by Section 2(5) of the Tax Credits Act 2002, the total cost of managing and paying tax credits was £587 million (2005-06: £467 million) and is accounted for in the Resource Accounts. This total cost was apportioned between Working Tax Credits (£203 million) and Child Tax Credits (£384 million).

Costs have increased from 2005-06 to 2006-07 mainly due to a change of accounting policy in apportioning Departmental overheads across processes, as a result of the introduction of new financial systems as part of the creation of HM Revenue & Customs.

4 Other Revenue

4.1 National Insurance Contributions

	Note	Net Revenue 2006-07 £ billion	Net Revenue 2005-06 £ billion
Revenue		91.5	90.9
Remissions and Write-offs	8.2	(0.4)	(0.4)
Net Revenue due to the National Insurance Funds and National Health Services for the year		**91.1**	90.5

	Net Revenue 2006-07 £ billion	Cash Paid to NIFs / NHS 2006-07 £ billion	Net Movement 2006-07 £ billion	Net Movement 2005-06 £ billion
National Insurance Fund – Great Britain	(69.1)	68.1	(1.0)	(3.0)
National Insurance Fund – Northern Ireland	(1.3)	1.4	0.1	–
National Health Services	(20.7)	20.2	(0.5)	(0.8)
Totals	**(91.1)**	**89.7**	**(1.4)**	(3.8)

The National Insurance Fund cash balances as at 31 March 2007 were:

- Great Britain: (£211.0 million) (opening balance at 1 April 2006: £299.7 million)
- Northern Ireland: (£186.5 million) (opening balance at 1 April 2006: (£81.7 million)).

The combined balance of £397.5 million is included within debtors (Note 6).

National Insurance Contributions are paid over to the National Insurance Funds and National Health Services when received and not when accrued.

A significant proportion of contributions collected through Pay As You Earn (PAYE) are received as a combined payment of Income Tax and Class 1 National Insurance Contributions with no notification of the actual classification between Income Tax and National Insurance Contributions. These receipts have been classified between Income Tax and National Insurance using an algorithm based on PAYE receipts where the classification between Income Tax and National Insurance Contributions is known.

4.2 Certificates of Tax Deposit

Under the Certificate of Tax Deposits (CTD) scheme, HMRC accepts deposits from people liable to UK taxes and other liabilities that are listed in the current Prospectus (details can be found at www.hmrc.gov.uk). HMRC administers this scheme on behalf of HM Treasury, and the accounts of the National Loans Fund include the principal and accrued interest for all issued CTDs as at 31 March.

Delays in processing between the issue and redemption of CTDs and the transfer of funds to and from the National Loans Fund can result in balances at the year end; these balances are included within debtors or creditors on the Trust Statement Balance Sheet.

	CTD Issues 2006-07 £ million	CTD Redemptions 2006-07 £ million	CTD Total 2006-07 £ million	CTD Total 2005-06 £ million
Receipts	99	58	157	269
Payments	(100)	(61)	(161)	(264)
			(4)	5
Balance at 1 April			1	(4)
Balance at 31 March (Included in (debtors)/creditors)			**(3)**	1

4.3 Student Loan Recoveries

	2006-07 £ million	2005-06 £ million
Receipts	461	181
Payments	(450)	(170)
Balance	11	11
Balance at 1 April	(3)	(14)
Balance at 31 March (Included in creditors/(debtors))	**8**	(3)

The Department recovers Student Loans through the taxes system on behalf of the Department for Education and Skills (DfES), from those former students eligible to make repayments. Student Loan recoveries are estimated on the basis of the end of year employer returns processed before the Trust Statement is certified. The actual value of Student Loan recoveries is established later in the year, and the difference between the estimate and the actual receipts is paid to the DfES and disclosed in the Trust Statement for the following year.

There is a net underpayment of £8 million to the DfES at 31 March 2007 which, with HM Treasury authorisation, will be rectified by increasing payments to DfES during 2007-08. Any adjustments to the annual figures will be reflected in next year's Trust Statement.

5 Taxation Revenue due to the Isle of Man

Under the Isle of Man Act 1979, the Isle of Man Government is entitled to the following share of common revenues collected in the UK by HMRC.

	Net Revenue 2006-07 £ million	Net Revenue 2005-06 £ million
Cash Payments	185	346
(Less closing creditor)/add closing debtor	(22)	1
Add closing creditors	22	22
Total Taxation Revenue due to Isle of Man	**185**	369

6 Debtors and Accrued Revenue Receivable

	Debtors as at 31 March 2007 £ billion	Accrued Revenue Receivable as at 31 March 2007 £ billion	Total as at 31 March 2007 £ billion	Total as at 31 March 2006 £ billion
Debtors and Accrued Revenue Receivable due within one year:				
Income Tax	5.7	24.8	30.5	30.1
Value Added Tax	7.7	21.7	29.4	26.1
Corporation Tax	1.4	14.1	15.5	14.6
Hydrocarbon Oils Duties	0.1	1.2	1.3	1.2
Alcohol Duties	0.5	0.5	1.0	0.9
Stamp Taxes	0.2	1.1	1.3	0.9
Tobacco Duties	0.1	1.1	1.2	1.7
Other Taxes and Duties	1.0	1.8	2.8	2.6
Tax Credit Overpayments	0.8	–	0.8	0.9
National Insurance Contributions	2.8	14.3	17.1	15.4
National Insurance Funds and NHS	0.4	–	0.4	–
Prepayments	0.1	–	0.1	–
Totals before Provision	20.8	80.6	101.4	94.4
Less Provision	(5.5)	–	(5.5)	(4.2)
	15.3	**80.6**	**95.9**	90.2
Debtors due after more than one year:				
Inheritance Tax	0.7	–	0.7	0.7
Tax Credit Overpayments	3.1	–	3.1	2.7
Totals before Provision	3.8	–	3.8	3.4
Less Provision	(1.0)	–	(1.0)	(0.9)
	2.8	**–**	**2.8**	2.5
Totals before Provision	**24.6**	**80.6**	**105.2**	97.8
Less Provision (Note 8.4)	(6.5)	–	(6.5)	(5.1)
Total	**18.1**	**80.6**	**98.7**	92.7

Debtors represent amounts due from taxpayers or traders in respect of established liabilities for which, at the Balance Sheet date, payments had not been received.

Accrued Revenue Receivable represents amounts not yet due or received from taxpayers, but relating to the financial year (or for certain Corporation Tax liabilities to an earlier financial year) where these have not been included in debtors. The majority of these amounts have been estimated using statistical models based on projections of the most recent revenue flows and forecasts of economic variables on which future revenue flows depend.

6.1 Accounting Estimates

Estimates have been provided to support the accrued revenue receivable balances and accrued revenue liability balances where tax returns reporting taxpayer liabilities are not filed until after the Trust Statement has been published.

Estimates have been provided to support the accrued revenue receivable balances for Income Tax collected under PAYE, self assessment, Company Income Tax and Tax Deducted from Savings Income; Corporation Tax, Value Added Tax, Petroleum Revenue Tax, Stamp Duty Land Tax, Stamp Duty Reserve Tax and National Insurance Contributions (Class 1 collected through PAYE and Class 4 collected through self assessment). Accounting estimates have also been provided to support the Value Added Tax and National Insurance Contributions accrued revenue liability balances.

Descriptions of the estimation techniques and details of the underlying assumptions have not been provided for Income Tax collected under PAYE, Petroleum Revenue Tax, Stamp Taxes, Company Income Tax and Tax Deducted from Savings Income as the estimated monetary amounts are either relatively small or not deemed to be particularly sensitive to changes in the underlying assumptions.

6.1.1 Corporation Tax

Corporation Tax for large onshore companies is paid by four quarterly instalment payments (QIPs). North Sea companies, who previously paid QIPs, have from 2006-07 moved to paying their Corporation Tax liabilities in three instalment payments (TIPs). Separate accrued revenue receivable estimates have been calculated for onshore and North Sea companies.

Onshore companies

Accrued revenue receivable has been estimated where between one and four QIPs for onshore companies have been received using a model that forecasts companies' Corporation Tax liabilities based on the number and value of QIPs received.

Corporation Tax is assumed to accrue evenly throughout the companies' accounting periods. Assumptions for the proportions of companies' Corporation Tax liabilities that are remitted with each QIP and adjustments for overpayments and late payments of Corporation Tax liabilities are based on historical trends of Corporation Tax liabilities and receipts. The principal assumptions are shown below:

	2006-07 (per cent)	2005-06 (per cent)
Proportion of Corporation Tax liability remitted with first QIP	26.6	26.7
Proportion of Corporation Tax liability remitted with second QIP	23.8	26.7
Proportion of Corporation Tax liability remitted with third QIP	26.2	26.7
Adjustment for overpayment of Corporation Tax liabilities	(10.0)	(9.3)
Adjustment for late payment of Corporation Tax liabilities	6.0	4.5

The proportions of Corporation Tax liability remitted with the first, second and third QIPs are now being separately calculated for each relevant accounting period. The proportions shown above for 2006-07 are the overall weighted averages.

For accounting periods where no QIPs have been received, accrued revenue receivable has been estimated based on prior year outturn liabilities at a sectoral level adjusted for forecast growth in Corporation Tax liabilities. The annual growth rates applied are based on the economic assumptions that are provided by HM Treasury and used to forecast Corporation Tax revenues for the March 2007 Financial Statement and Budget Report.

For 2006-07, separate growth rates were used for onshore and North Sea companies following changes to the structure of the forecast model. The growth rates for onshore companies, as well as the overall average growth rate used in 2005-06 for both onshore and North Sea companies, are shown below:

Annual Growth in Corporation Tax liabilities	2006-07 (per cent)	2005-06 (per cent)
Onshore companies	7.5	14.7

North Sea companies

The accrued revenue receivable for 2006-07 is almost entirely attributable to companies with accounting periods ending December 2007. These are accounting periods for which no TIPs have been received and so the estimate is primarily based on prior year outturn liabilities adjusted for forecast growth in North Sea companies' Corporation Tax liabilities. The growth rate used for 2006-07 is shown below.

Annual Growth in Corporation Tax liabilities	2006-07 (per cent)
North Sea companies	10.1

6.1.2 Self Assessment Income Tax and National Insurance Contributions Class 4

Accrued revenue receivable represents accrued liabilities for 2006-07 where payment is not yet due at 31 March 2007. The estimation process has three stages:

(i) estimation of accrued liabilities for 2006-07. The estimates used are those prepared for Budget 2007 on the basis of the economic assumptions provided by HM Treasury. The most important of these is that self-employment profit is assumed to have risen by 4.6 per cent in 2006-07 (2005-06: 4.4 per cent);

(ii) deduction from the 2006-07 accrued liabilities of relevant payments by 31 March 2007. An estimate of these payments is provided by the 'head of duty analysis', a statistical apportionment of total self assessment receipts of income tax, NICs, capital gains tax and student loan repayments between these four components. The breakdown is estimated from separate information on self assessment liabilities;

(iii) a further deduction for payments due by 31 March but not made by that date (these are included in the debtor balances). The amounts relate to payments on account due on 31 January. The breakdown of the total between income tax and NICs is made by statistical estimation.

6.1.3 Value Added Tax

VAT registered businesses in the UK are required to submit VAT returns either monthly, quarterly or annually one month in arrears of the end of the relevant accounting period. Consequently, some, but not all, information relating to VAT accrued revenue receivable and liable was available at the time of production.

To facilitate the creation of estimates for the remaining elements, historical time-series have been created to show the total accrued revenue in each month for each of the different reporting cycles. Established statistical forecasting techniques have then been applied to construct estimates for the more recent periods based on the resulting trends. These have been combined with actual return data and adjusted to account for any payments or repayments relating to these returns that were made prior to the financial year end. This provides an estimate of accrued revenue receivable and liable via the regular return process. The statistical models selected on the basis of historical data provide a reliable indication of future accrued revenue receivable and liable.

To construct final estimates of accrued revenue receivable and repayable, a number of further adjustments have been made to reflect VAT that is accounted for outside the process described above. The principal adjustments relate to import VAT, repayments paid to government departments and Officers' Assessments of errors in submitted VAT returns. These are based largely on actual return information although some forecast element remains.

6.1.4 Uncertainty Around the Estimates

Statistical models are used to derive the estimates. These are based on a combination of projections based on the most recent revenue flows and forecasts of economic variables on which future revenue flows depend. The forecasts are based on what is believed to be the relevant inputs. However, because of the areas of uncertainty involved, there will inevitably be differences between the forecasts and future outturns. These differences arise because of the need to make judgements on areas of uncertainty and are not indicative of deficiencies in the models. It is believed that the levels of variation are acceptable with a maximum likely overall uncertainty expected to be some £4 billion, which does not significantly affect the reported position. This figure is equivalent to less than 1 per cent of total revenue reported in the Statement of Revenue and Expenditure.

This maximum likely overall uncertainty is based on a combination of evidence from the performance of the models over five years and the judgement of professional departmental economists and statisticians having substantial experience of forecasting in the area of direct taxes.

7 Creditors, Accrued Revenue Liabilities and Deferred Revenue

A breakdown of Creditors, Accrued Revenue Liabilities and Deferred Revenue falling due within one year is as follows:

	Creditors as at 31 March 2007	Accrued Revenue Liabilities as at 31 March 2007	Deferred Revenue as at 31 March 2007	Total as at 31 March 2007	Total as at 31 March 2006
	£ billion	£ billion	£ billion	£ billion	£ billion
Value Added Tax	2.3	7.9	–	10.2	12.1
Corporation Tax	12.6	–	0.3	12.9	10.9
National Insurance Funds and the NHS	–	17.1	–	17.1	15.6
Other Revenue Creditors	0.1	–	0.3	0.4	0.5
Sundry Creditors	0.1	–	–	0.1	0.1
Total	**15.1**	**25.0**	**0.6**	**40.7**	39.2

Creditors are amounts established as due at the Balance Sheet date but payment has not been made in full.

There are two distinct types of Accrued Revenue Liabilities. These comprise, first, amounts due to VAT traders that have an established revenue liability relating to the financial year, but the date the claim is received is after the balance sheet date; secondly amounts of accrued revenue receivable that will when received be passed to a third-party, e.g. National Insurance Contributions due to the National Insurance Funds and National Health Services.

Deferred Revenue includes duties and taxes paid in the current year that relate to future accounting periods.

There are no creditors which fall due after one year.

8 Bad and Doubtful Debts

8.1 Breakdown of Bad and Doubtful Debts

	Notes	2006-07	2005-06
		£ billion	£ billion
Revenue Losses	8.2	4.8	3.3
Increase in Provision for Doubtful Debts	8.4	1.4	1.0
Total Bad and Doubtful Debts		**6.2**	4.3

Bad and Doubtful Debts are made up of revenue losses and the movement in the provision for doubtful debts. The split is shown below:

8.2 Revenue Losses

	Remissions 2006-07 £ million	Write-offs 2006-07 £ million	Total 2006-07 £ million	Remissions 2005-06 £ million	Write-offs 2005-06 £ million	Total 2005-06 £ million
Income Tax	52	600	652	53	509	562
Value Added Tax	75	2,881	2,956	18	1,468	1,486
Corporation Tax	3	214	217	3	235	238
Alcohol Duties	–	35	35	1	42	43
Tobacco Duties	–	23	23	–	75	75
Capital Gains Tax	14	27	41	10	17	27
National Insurance Contributions	10	436	446	13	445	458
Tax Credits	315	54	369	349	48	397
Other Remissions and Write-offs	1	15	16	1	30	31
Total Revenue Losses	**470**	**4,285**	**4,755**	448	2,869	3,317

For 2006-07, Capital Gains Tax is shown separately. This was previously included in the Other Remissions and Write-offs total.

Remissions are debts capable of recovery but HMRC has decided not to pursue the liability, for example, on the grounds of value for money or official error. Write-offs are debts that are considered to be irrecoverable because there is no practical means for pursuing the liability.

The split of values between remissions and write-offs for some direct taxes is not available on a financial year basis. Where information is not available the split has been calculated using averages across three previous years.

The Department is continuing to review the alignment of revenue loss policies along with accounting and reporting requirements across HMRC. Some initial changes have been introduced to align authorisation levels and losses terminology.

National Insurance Contribution write-offs include £16 million (2005-06: £63 million) of Class 2 contributions no longer collectable as they became time barred in year.

8.3 Revenue Losses – Cases over £10 million

There were 70 cases (2005-06: 19 cases) where the loss exceeded £10 million, totalling £2,399,092,902. Specific case details are shown below:

There was a remission of £186 million Tax Credits. In the first four years of the scheme approximately £300 million of overpayments arose through claimants incorrectly receiving Working Tax Credit (WTC) when they failed to notify HMRC when they stopped work. Part of this amount can be regarded as substituting for Income Support or Job Seeker's Allowance. Following a review by HMRC it was concluded that it was not cost effective to seek recovery of part of the debts (£186 million) but further work will be completed to recover the balance.

There was a remission of £27,068,248 VAT in respect of a trader who provides education services. The trader was incorrectly advised by HMRC that they were exempt from VAT under the provisions of Schedule 9 of the VAT Act 1994, and as a result failed to account for output tax, (or claim input tax), that was properly due. The VAT was remitted on the grounds of misdirection. A further amount of £36,357,664 was written-off as it was out of time for assessment and therefore irrecoverable.

There was a remission of £13,913,773 VAT for a trader operating as a not-for-profit company, funded mainly by Government departments, and set up to promote energy saving and the use of renewable energy sources. They received an incorrect ruling from HMRC that led them to overclaim input tax in respect of non-business activities. The VAT was remitted on the grounds of misdirection. A further amount of £16,194,125 overclaimed input tax was written-off as it was out of time for assessment and therefore irrecoverable.

There was a remission of £15,124,117 VAT and interest for a national furniture retailer. The trader had operated a scheme under which they treated 20 per cent of the selling price of the furniture as insurance against failure of the item, and not as part of the cost of the furniture itself. Following investigations, HMRC raised assessments for the VAT undeclared. The trader appealed for a reduction of the assessments, by which time they were in significant financial difficulties. An investor was prepared to fund the company for part of the debt. Negotiations between HMRC and the trader's advisors resulted in an Agreement under Section 85 of the VAT Act 1994, whereby the trader agreed to pay a proportion of the debt (£19,012,979) and the remainder would be remitted. Two years later the business continues to trade, employing several thousand people and makes VAT payments of around £40 million each year.

There was a write-off of £11,330,924 (tobacco excise duty, customs duty, VAT and interest) relating to a cigarette diversion fraud. All options to recover the debt were tried but without success. Companies House confirmed the business was dissolved and the trader was established as missing.

There were 63 write-offs relating to Missing Trader Intra-Community Fraud (MTIC) over £10 million each, totalling £2,069,093,409. Most of these cases have been subject to proactive insolvency action and dividends in respect of some of the lost revenue are expected in the future.

There were two write-offs relating to insolvency over £10 million each. They were for Corporation Tax, Income Tax, Capital Gains Tax, National Insurance Contributions and interest, totalling £24,010,642.

8.4 Provision for Doubtful Debts

	2006-07	**2005-06**
	£ billion	£ billion
Balance as at 1 April	5.1	4.1
Increase in Provision for Doubtful Debts	1.4	1.0
Balance as at 31 March	**6.5**	5.1

Debtors in the Balance Sheet are reported after the deduction of the provision for doubtful debts. This provision has been estimated using debt analysis, trend analysis (including use of the revenue loss figures from the previous year) and internal expert opinion.

9 Provision for Liabilities

	Legal Claims 2006-07 £ million	Legal Claims 2005-06 £ million
Balance at 1 April	34	82
Provided in the year	2,200	18
Provision not required written back	–	(24)
Provision utilised in the year	(34)	(42)
Balance at 31 March	**2,200**	34

Provision has been made for legal claims brought by taxpayers against HMRC. The information usually required by FRS 12 is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the legal claims against the Department. Legal claims, where it is probable that HMRC will be required to settle the claim and is unable to reliably estimate the amount, or where it is possible that the Department will be required to settle the claim, are disclosed as contingent liabilities in note 11.

10 Balance on Consolidated Fund Account

	2006-07 £ billion	2005-06 £ billion
Balance on Consolidated Fund Account as at 1 April	53.5	55.0
Net Revenue for the Consolidated Fund	323.2	298.0
Less amount paid to Consolidated Fund	(321.4)	(299.5)
Balance on Consolidated Fund Account as at 31 March	**55.3**	53.5

11 Contingent Liabilities

11.1 Taxes subject to legal challenge

HMRC is engaged in legal proceedings with taxpayers across a range of cases, which include some in which reference to the European Court of Justice may be required, as well as cases wholly within the jurisdiction of United Kingdom courts. Depending on the judgement of the relevant court, in some or all of these cases, there may be reductions in revenue and/or repayments of tax. The issues raised in litigation vary. For cases where it is probable that HMRC will be required to settle the legal claim, it has not been practicable to estimate the financial effect. In other cases HMRC considers it possible that it will be required to settle the claims.

In certain circumstances where tax is assessed, the taxpayer has the legal right to apply for the postponement of payment in the case of a dispute. Pending the tribunal decision the tax is not legally due and cannot be collected. Consequently HMRC neither recognise revenue nor disclose any contingent liabilities in respect of these cases.

The information usually required by FRS 12 is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the legal claims against the Department.

11.2 Consequences of oil field decommissioning on Petroleum Revenue Tax

The 1975 Oil Taxation Act as subsequently amended allows for Petroleum Revenue Tax (PRT) losses arising from the decommissioning of infrastructure associated with oil and gas fields subject to PRT to be carried back indefinitely. Estimates of the cost of decommissioning vary widely, ranging from £10 billion to £20 billion at today's prices in respect both of fields subject to PRT and those not. In so far as part of this expenditure generates PRT losses that are carried back then the PRT liabilities for the periods to which the losses get carried back may be less than originally measured. So any accrued revenue receivable for those periods will be less than originally thought. The cost of decommissioning remains uncertain since it will be determined by the domestic and international obligations that prevail when abandonment takes place. The majority of the expenditure is likely to be spread over the next 20 years or so but this depends on the extent to which North Sea output can be sustained, so the timing is uncertain. However, for certain fields decommissioning has already taken place.

12 Related-Party Transactions

Due to the nature of HMRC's business, we have a large number of transactions, relating to taxation income, with other Government Departments, other Central Government bodies, managerial staff and taxpayers. During the year none of the Board members or other related parties have undertaken material transactions with HMRC.

13 Post balance sheet events

There are no reportable post balance sheet events. The financial statements were authorised for issue by the Principal Accounting Officer on 10 July 2007.

Accounts Direction Given by HM Treasury

ACCOUNTS DIRECTION GIVEN BY HM TREASURY IN ACCORDANCE WITH SECTION 5(2) OF THE GOVERNMENT RESOURCES AND ACCOUNTS ACT 2000 AND WITH SECTION 2(3) OF THE EXCHEQUER AND AUDIT DEPARTMENTS ACT 1921

1. Her Majesty's Revenue and Customs (HMRC) shall prepare a **Resource Account** for the year ended 31 March 2007 in compliance with the accounting principles and disclosure requirements of the edition of the Government Financial Reporting Manual issued by HM Treasury ("FReM") which is in force for that financial year.
2. The Resource Account shall be prepared so as to give a true and fair view of the state of affairs as at 31 March 2007 and of the net resource outturn, resources applied to objectives, recognised gains and losses and cash flows for the year then ended. The Resource Account shall also be prepared so as to provide disclosure of any material expenditure or income that has not been applied to the purposes intended by Parliament or material transactions that have not conformed to the authorities which govern them.
3. Compliance with the requirements of the FReM will, in all but exceptional circumstances, be necessary for the accounts to give a true and fair view. If, in these exceptional circumstances, compliance with the requirements of the FReM is inconsistent with the requirement to give a true and fair view, the requirements of the FReM should be departed from only to the extent necessary to give a true and fair view. In such cases, informed and unbiased judgement should be used to devise an appropriate alternative treatment, which should be consistent with both the economic characteristics of the circumstances concerned and the spirit of the FReM. Any material departure from the FReM should be discussed in the first instance with HM Treasury.
4. HMRC shall prepare a **Trust Statement** for the financial year ended 31 March 2007 which shall give a true and fair view of the state of affairs relating to the collection and allocation of taxes, duties, National Insurance Contributions, tax credits and Student Loan recoveries and any other revenues and related expenditures administered by the Department and the revenue income and expenditure and cash flows for the financial year then ended.
5. When preparing this Statement, HMRC shall have regard to the guidance given in the attached Appendix to this Direction. HMRC shall also agree the format of the Principal Accounting Officer's Foreword to the Trust Statement and the supporting notes (including the accounting policies particularly with regard to revenue recognition) with HM Treasury. Regard shall also be given to all relevant accounting and disclosure requirements given in *Government Accounting* and other guidance as issued by HM Treasury, the principles underlying UK Generally Accepted Accounting Practice and, for tax credits, guidance issued by the Organisation for Economic Co-operation and Development.
6. The Resource Account, together with the Trust Statement, shall be transmitted to the Comptroller and Auditor General for the purpose of his audit examination and report by a date agreed with the Comptroller and Auditor General and HM Treasury to ensure compliance with the administrative deadline for laying the audited accounts before Parliament before the Summer Recess.

7. The Resource Account and Trust Statement, together with this direction, (but with the exception of the appendix), shall be laid before Parliament in one volume containing both financial statements and the Report produced by the Comptroller and Auditor General under section 2(2) of the Exchequer and Audit Departments Act 1921 as amended by the Government Resources and Accounts Act 2000.

8. This Direction supersedes the Direction dated 7 February 2006.

DAVID WATKINS
Head of the Financial Reporting Policy Team, Government Reporting, HM Treasury
14 December 2006

National Audit Office

HM REVENUE & CUSTOMS 2006-07 ACCOUNTS

The Comptroller and Auditor General's Standard Report

Presented to the House of Commons under Section 2 of the Exchequer and Audit Departments Act 1921 as amended by the Government Resources and Accounts Act 2000

This Report is published alongside the 2006-07 Accounts of HM Revenue & Customs

John Bourn
Comptroller and Auditor General
6 July 2007

SUMMARY

Introduction

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

2 Whilst recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, the National Audit Office's work in 2006-07 provided assurance that HM Revenue & Customs has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That assurance is subject to reservations about the level of claimant error and fraud in the award of tax credits (see Part Two of this report). The report also includes observations on the collection of income tax through Self Assessment and PAYE and the administration of Value Added Tax.

Corporation tax: film tax relief

3 The Finance Act 2006 introduced new rules for the taxation of film production and in particular, a new tax relief for the production of British cinema films. The Department, in collaboration with the Department for Culture, Media and Sport (DCMS), has designed the new relief to try to avoid the possibilities of it becoming vulnerable to avoidance activity. The Department considers the fact that the relief may only be claimed by film production companies will help to mitigate this risk. The previous relief was open to companies and individuals whose involvement in film making was confined to providing or arranging finance. These groups are now excluded from the new arrangements.

4 The Department recognises that there are still residual tax avoidance risks, as individual companies may seek to push the boundaries of what may be categorised as qualifying expenditure for film production. As the Department receives claims for film tax relief it will start to construct a risk profile built around experience of dealing with compliance issues, rather than as at present, based on predictive analysis of behaviour. The Department will also assess the operation of the new film tax relief once it has been in place for at least a year. The Department considers that experience with similar policy measures suggests that the overall impact is only clear in the longer term.

5 Against this backdrop, it is important for the Department to ensure that:

- the Memorandum of Understanding between the Department and DCMS sets out clearly the respective roles of the two departments for management of the tax relief. In particular, the responsibilities that DCMS has for the certification process; and
- the processes and procedures that it puts in place to monitor the costs associated with the tax relief are sufficient to meet the commitment to do this under the Regulatory Impact Assessment. The Department should also ensure that its management information systems are able to identify and aggregate the cost of this relief.

Tax Credits

6 During 2006-07 the Department paid a net £18.7 billion in tax credits and an average of 5.5 million families received provisional 2006-07 awards. The Department estimates that year end adjustments to awards meant it overpaid £1.7 billion and underpaid £549 million in 2005-06. In the first three years since the scheme was introduced, the Department calculates that these adjustments, and other small changes to entitlement after the finalisation of awards, have led to a debt of £6.0 billion. It has also identified £600 million from in year adjustments to 2006-07 awards and will identify further overpayments for this year once awards are finalised. By the end of March 2007 the Department had collected £2.0 billion of this debt and written off £0.7 billion. £3.9 billion of overpayments remain to be collected by the Department. It has provided for £1.6 billion in respect of doubtful debts.

7 In the 2005 Pre-Budget Report the Chancellor announced a number of measures which were designed to provide greater certainty to claimants, particularly when families see a rise in income. One important change, for awards for 2006-07 and subsequent years, is the increase from £2,500 to £25,000 of rises in income which are disregarded when finalising awards. The Department estimates that this alone will reduce overpayments by between £400 million – £600 million per annum. The effect of the other changes is harder to establish as they seek to influence claimants' behaviour by encouraging the prompter reporting of changes in circumstances. The Department estimates that the changes together will eventually reduce the value of overpayments by one third. It will publish details on finalised 2006-07 awards in May 2008 which will provide more information on the effect of these measures.

8 The Department terminates an award if the claimant does not report their actual income, fails to return a signed award notice or did not qualify for tax credits. The Department has examined a sample of the 228,000 awards terminated in 2004-05 to improve its understanding of claimant behaviour. The Department estimates that some 180,000 of the awards terminated in 2004-05 were due to the claimant's failure to report their actual 2003-04 incomes, although of these 22,000 new awards were subsequently made to the same claimants before the year end. But there was insufficient evidence to conclude why the remaining claimants had not finalised their awards. In the absence of this information it is not possible to discount the risk that some of these claims were fraudulent. The Department is now undertaking a more comprehensive exercise to examine why claimants fail to finalise their awards.

9 In June 2007, the Department completed its testing of 2004-05 awards, based on 4,500 random enquiries. As a result of this, the Department estimates that claimant error and fraud resulted in between £1.04 billion to £1.30 billion (7.3 to 9.1 per cent of the final value of awards) being paid to claimants to which they were not entitled. The levels in 2003-04 were £1.06 billion to £1.28 billion (8.8 to 10.6 per cent). It also estimates that claimant error resulted in between £200 million to £350 million (1.4 to 2.4 per cent) not being paid to claimants to which they were entitled. The levels in 2003-04 were £190 million to £280 million (1.6 to 2.3 per cent). These levels are unacceptably high, and whilst the Department has made changes to its compliance procedures since 2004-05, there is currently no evidence to demonstrate a lower estimate for 2006-07. Consequently I have qualified my opinion on the Trust Statement.

10 It is important that the Department's work provides an accurate view of levels of error and fraud and it is looking to enhance the quality of this work by using specialist teams to undertake testing. It also needs earlier assessments of the overall level of error and fraud to improve its understanding of the effect of its compliance work.

11 In 2006-07 the Department carried out 137,930 checks on claims it assessed as higher risk. It has identified incorrect payments made of £151 million and prevented incorrect payments of £291 million (£250 million and £447 million in 2005-06). The reduction on 2005-06 is primarily due to fewer attacks by organised fraudsters, following the closure of the tax credit internet site in December 2005. The Department is developing a framework for validating the identity of individuals and will only re-open the tax credit internet system once this work is complete, which is unlikely to be before July 2008.

12 The Department's compliance examinations affect 2.5 per cent of awards, although all claims are subject to a series of checks before they are put into payment. The Department is now considering a broader range of compliance activity to increase its coverage of the tax credits population, aimed at increasing compliance and reducing levels of claimant error and fraud. The Department will always need to perform checks on claims assessed as high risk before payment to safeguard against error and fraud. The Department is now considering whether, in addition to these detailed compliance examinations, more frequent engagement with other groups of tax credit claimants would assist in the deterrence and prevention of error and fraud across the wider claimant population.

13 The Department has taken steps to improve the quality of service provided to claimants. It has a regular programme of enhancements to the tax credits computer system. The initial focus of these was to allow the Department to process new awards, make payments and renew awards. Subsequent software releases focused more on improving the service provided to claimants, for example by improving the information given. Software errors continue to result in some incorrect payments, and the Department has an ongoing programme of work to investigate these. The Department will continue to review the computer system to assess the impact of unresolved errors and it expects to address these through its improvement processes. On 26 May 2005, the Paymaster General announced steps to improve the Tax Credits system. The Department has undertaken a wide programme of work to deliver these commitments.

The collection of income tax through PAYE

14 In 2006-07 the Department collected £125 billion in income tax and £85 billion in National Insurance Contributions through Pay-As-You-Earn (PAYE), the government's largest source of tax revenue. The Department aims to ensure that individuals pay the right amount of tax on their income and to make it as easy as possible for employers and employees to meet their obligations.

15 As I noted in my 2005-06 report, the Department's PAYE computer systems are not well suited to the efficient administration of income tax where people have more than one job or change jobs on a regular basis. This is because the systems structure tax records around jobs rather than individual taxpayers. As a result, the Department can have difficulty identifying all relevant sources of income when calculating tax that should be paid. These difficulties have been compounded by inconsistent working practices within the Department as a consequence of staff not being aware of or failing to follow Departmental procedures, for example when adjusting tax codes for Benefits in Kind. Based on its most recent estimates, each year the Department may not be pursuing some £880 million of tax due, and taxpayers are likely to have overpaid around £340 million, resulting in potentially five million taxpayers not paying the right amount of tax.

16 During 2006-07 the Department introduced a number of measures to improve the quality of PAYE processing. It has mandated use of a spreadsheet tool to improve accuracy in coding. It has also operated a quality improvement process to help managers identify the cause of errors, take action to prevent them recurring and to help staff learn and improve. This consists of independent monthly checks across all processing offices to provide better information on overall performance against national standards. The Department has embarked on an initiative within local offices known as "Lean", as part of its Processing Pacesetter Programme. This aims to increase efficiency by eliminating duplication or reworking, improving accuracy, increasing productivity and reducing processing times. The Department's data shows that in 2006-07 the accuracy of processing improved in comparison with the previous years, but still fell short of target.

17 The Department has also taken steps to improve the timeliness of processing and ensure it takes into account all the information it holds on a taxpayer. It has dedicated resources to dealing with benefits in kind cases, but weaknesses in management information prevent it from assessing the effect on processing. For 2007-08 the Department has introduced a process to automate the coding of benefits in kind information, which should further improve the timeliness and accuracy of processing by reducing manual intervention. It also introduced a process to reduce the number of open cases automatically generated. These measures should improve the timeliness of processing, but in the absence of management information it is difficult to assess their effect. During 2007-08 the Department should quantify the success of these measures in reducing levels of error.

18 The Department recognises that real improvement in the operation of PAYE can only be achieved through fundamental changes in its computer systems. It therefore plans to move to its National Insurance computer system as the basis for administering the PAYE process. From 2008-09 this will allow all information on individuals to be brought together under their national insurance record and provide the Department with a complete view of a taxpayer's employment income.

19 The Department did not fully implement on time its new computer system to support the online filing of employers' 2004-05 year end returns. The system to validate and process online returns was not ready until June 2005, a number of weeks after the 19 May filing deadline. The Department implemented contingency arrangements to allow it to receive returns, but as a result the Department could not notify employers if their submissions were successful, identify returns that failed to meet quality standards, or accurately identify employers who missed the filing deadline. Because of these delays the Department accepted responsibility for resolving problems with returns, rather than referring them back to employers. But this caused significant pressures within the Department to deal with the resulting backlogs and meant some of the information needed to support the processing of individual records on the PAYE, National Insurance and student loans system was not available.

20 The Department made improvements for processing 2005-06 employer returns, involving identifying returns which did not meet quality standards; providing employers with better guidance; completing its implementation of all the functions provided by the computer system; and developing a comprehensive plan for processing returns. By the end of October 2006, just over four months after the deadline for submissions, the Department had successfully processed 86 per cent of the 2005-06 P14s, compared with 57 per cent in the equivalent period for 2004-05 returns. The number of returns that failed to meet its quality standards fell from 13 to 5 per cent. Early indications show that the 2006-07 online filing season has been more successful that the two previous years with 1.4 million returns received online, compared to 1.2 million for 2005-06, and 1.4 per cent of returns rejected with errors.

21 The Department has recovered from the problems encountered in 2004-05, but the measures needed in 2005-06 highlight the weaknesses of the original implementation. The Department needs to ensure it applies the lessons learned when extending the system to small employers and in-year filing. In particular it needs to ensure the system is fully developed and tested before it is introduced, external users are educated and supported in use of the system, and processing is supported by clear plans.

22 Since the early 1980's some pension providers have not deducted tax under PAYE from all pensions in payment. This is due to a combination of incorrect central guidance from the Department, inappropriate local agreements and failures by local offices to implement agreed procedures. The precise rationale for this is now unclear, although it is likely that these decisions were taken because staff did not consider the effect to be material against the administration savings for the Department and pension payers. But the Department now estimates this means it is potentially not receiving income tax from 420,000 pensions and its current estimate is that the tax loss is around £135 million per annum. The Department first became aware of this issue in April 2005 and corrected its guidance. But it did not explicitly notify pension providers of the changes and they generally went unnoticed. The Department has now begun a systematic programme of work to put these pensions on a proper footing but it does not intend to recover tax which has not been deducted in years earlier than 2007-08. The Department also needs to consider where else it has made judgements not to collect tax on the grounds of size and how it can obtain better assurance that its local offices are following central guidance. It also needs to ensure that when it changes guidance, this is accompanied by a wider programme of work to bring this to the attention of those affected and undertake compliance work to ensure these changes are implemented.

The collection of income tax through Self Assessment

23 Self Assessment was introduced in 1996 for taxpayers with a number of sources of income and with less straightforward financial affairs. It now affects 8.7 million self employed and higher rate PAYE taxpayers, 570,000 partnerships and 225,000 trusts. In 2006-07 the Department collected £26.6 billion tax through the system, after repayments. In 2006-07, 88.5 per cent of Self Assessment taxpayers paid the amounts owed on time, against the Department's target of 89.8 per cent. The average monthly debt owed to the Department in 2006-07 was £3.1 billion, an increase of £250 million on the previous year.

24 The Department has changed the Self Assessment process to ease the burden on certain taxpayers. Since 2004-05 the Department has removed 1.6 million taxpayers with very straightforward affairs from the system, although this reduction has been largely offset by increasing numbers of self employed and highly paid employees coming into the system. In April 2005 the Department simplified the Self Assessment process for nearly 1.5 million people with simpler tax affairs by issuing a new Short Tax Return.

25 The administration of Self Assessment involves a number of business areas within the Department, ranging from teams processing returns and undertaking compliance enquiries to collecting debt and providing computer support. In 2006 the Department established a new integrated governance structure to manage Self Assessment, which aims to improve coordination and enhance collaboration across the different parts of the Department involved in administering the process. These arrangements therefore provide a more effective basis for administering Self Assessment. But the structure does not include the Department's compliance activities over Self Assessment. The Department should consider the scope for the closer integration of compliance.

26 Online services offer considerable benefits in the efficient and effective administration of tax and Self Assessment has been at the forefront of the Department's drive to engage with the taxpayer through the internet. The Department has made significant progress in increasing the percentage of returns filed online and is currently meeting its target of 35 per cent of Self Assessment returns to be filed online for 2007-08.

27 In 2006-07 around one million taxpayers did not submit their returns by the 31 January deadline and the Department failed to meet its target that 91.5 per cent of returns were filed on time. The results were lower than those for the previous two years. The Department's early analysis suggests that this was primarily because of reduced media advertising in 2006-07 and problems with its campaign to contact taxpayers new to Self Assessment. In addition to learning from its experience in 2006-07, the Department should examine the effectiveness of the existing penalty regime and consider whether new or greater sanctions are needed to change taxpayer behaviour.

28 The Department operates a penalty system to discourage taxpayers from submitting incorrect returns. The Department often uses abatements depending on the seriousness of the offence, but the penalty charged is effectively open to negotiation which inevitably leads to inconsistency. In recent years the level of abatements has risen and there is little difference between penalties for neglect and more serious cases of fraud. The Department has also found that whilst the arrangements are understood by tax advisers, they are not visible nor understandable to taxpayers. In the 2007 Budget the Government announced a new approach to penalties for incorrect returns. This aims to make a clear distinction between those who make a genuine mistake – who will not incur a penalty – and those who deliberately understate their tax liability. These reforms should help the Department better tailor its approach to address the underlying taxpayer behaviour.

29 The Department assesses the accuracy of filed returns through an annual random enquiry programme. Based on the latest results available for 2001-02, 33 per cent of returns were filed inaccurately. The Department estimates this meant that between £2.5 billion to £3.2 billion tax was at risk in 2001-02 due to inaccurate returns. Some 40 per cent of the tax at risk relates to one per cent of taxpayers. The Department should target groups who are more prone to non-compliance, for example those new to self-employment and subcontractors in the construction industry.

30 The Department has reduced the number of compliance enquiries undertaken in recent years, although the yield generated from this work has increased. The Department has also established specialist teams to tailor its approach to the Self Assessment population, including individuals with complex tax affairs and inward expatriate employees and their employers. The yield from this work has grown consistently over recent years and exceeds the Department's targets. But not having up to date information on total levels of tax at risk reduces the Department's knowledge of overall non-compliance. The Department recognises the need to make earlier and more regular assessments of tax at risk to assess the effectiveness of its compliance activities, inform its risk assessment process and identify new areas for targeting compliance resources. The Department has formed the Risk and Intelligence Service to help take this work forward.

31 Self Assessment repayments are generated automatically following the processing of self assessment returns. A lack of formalised accountabilities has historically made it difficult for the Department to establish central oversight and responsibility over repayments, including the extent to which agreed controls were being operated. Deficiencies in management information have also made it difficult to establish the degree to which these controls could prevent or detect error and irregularities. The Department has evidence of organised criminal activity to obtain fraudulent repayments, sometimes using unsolicited returns. It introduced improved controls in April 2007 to specifically monitor unsolicited returns and is reviewing the effectiveness of its existing automated checks for identifying high risk repayments which require checking before they are made. It needs to closely monitor the success of these measures in deterring organised crime.

Value Added Tax

32 The Department strengthened its operational and legislative measures to tackle missing trader fraud, following an increase in fraudulent activity in 2005-06. The United Kingdom's application for a 'reverse charge' on certain goods was approved by the Council of the European Union in April 2007 and introduced from the 1 June 2007. However, the 'reverse charge' does not extend to the whole range of electronic goods requested in the original application. It has been limited to goods commonly associated with the fraud, i.e. mobile phones and computer chips. In addition, the derogation will only be applicable for the period up until April 2009, at which time its effectiveness will be reviewed by the European Commission. There is a risk that the organised criminals behind the fraud will divert their attention to other goods not covered by the derogation. The Department, however, recognises that effective monitoring of trading activity will prove crucial in tackling any mutations and preventing an escalation of fraudulent activity in other areas.

33 The extended verification of repayment claims has, according to the Department's operational indicators, reduced the level of fraudulent activity in the UK. However, missing trader fraud is a European Union wide problem as fraudsters exploit EU VAT rules that allow intra-Community goods to be traded VAT-free. The Department should, therefore, continue to work with other Member States in identifying and tackling these criminals, and seek a long term solution to the problem, which may include an overhaul of the current VAT system. However, any changes would need to reduce considerably the possibilities for missing trader fraud, exclude any opportunities for new types of fraud, and not generate a disproportionate administrative burden for traders and authorities.

34 The Department has strengthened its registration controls to prevent fraudsters from obtaining a VAT registration number. Some five per cent of new applications (285,176 in 2006-07) are subject to detailed anti-fraud checking which in 2006-07 delayed processing by up to 12 weeks. The introduction of risk advisors at the registrations units, however, has enhanced the risk assessment process. The number of suspect registration applications refused increased from 3,513 in 2005-06 to 6,073 in 2006-07.

35 The processing of registration applications can be delayed if they are incomplete and/or inaccurate. The Department has a public service agreement target to increase the number of complete and accurate applications received to 50 per cent. Through making the application form user friendly and providing focused guidance for businesses, the Department achieved an outturn of 49 per cent in 2006-07 compared with 27 per cent in 2005-06. The Department also set a new target of processing 95 per cent of all applications within 14 days by March 2008. The interim measure for this target was 30 per cent achievement by March 2007. Of the 285,176 applications received, 27 per cent were processed within the target date. However, progress will need to be significant if the Department is to achieve its 2008 target.

36 The Department has a responsibility for ensuring that correct VAT repayments are paid promptly. Repayment supplements amounting to five per cent of the VAT claim or £50 (whichever is the greater) is paid if repayments are not paid within 30 days of being submitted. It also has to protect VAT revenue, and therefore has controls in place to check VAT repayment claims. In 2006-07 the Department met its target of processing 90 per cent of correct repayment claims within 10 days. The checks, however, identified and prevented over-claims arising from error or fraud totalling £603 million. Repayment supplements in 2006-07 totalled £8.68 million, of which £3.9 million arose as result of the Department's measures in tackling missing trader fraud. It also included £728,216 which was incurred following a systems error that, most importantly, took six calendar days to resolve as the Department did not have in place the IT service level or support arrangements necessary to resolve the issue more quickly. The Department has implemented daily checks to ensure that a similar system problem does not recur, and is currently considering improvements to the wider service level and support arrangements around this process to make sure that action is taken promptly should a similar process problem arise in the future.

PART ONE

Introduction

Background

1.1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Revenue & Customs (the Department) on behalf of the House of Commons to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. I am also required by that Act to examine the correctness of the sums brought to account; and to report the results to the House of Commons. My audit certificate and report on the Trust Statement account and this report together satisfy that requirement.

1.2 This part of my report sets out the context for my audit of revenue and is in two sections. The first explains the scope of my audit, the audit approach applied and the audit conclusion from my examination of the revenue accounts. The second section describes the developments in the audit landscape which provide the context for my audit. In particular, the report considers:

- the modernising powers, deterrents and safeguards initiative;
- the review of on-line services by Lord Carter of Coles;
- the Department's Transformation Programme;
- the Accounting Officer's Statement on Internal Control;
- the Department's approach to managed service companies; and
- Corporation tax: film tax relief (the new arrangements announced under the Finance Act 2006).

Scope of the audit and audit conclusion

Audit approach

1.3 In examining the extent to which the Department has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue and whether the Department is duly carrying out these regulations and procedure, my staff have developed an audit approach that incorporates a range of audit work across the Department's activities and tax streams. Amongst other things, my staff have:

- conducted specific work on areas of the Department's operations and tax streams, including:
  - the Department's response to the challenges of delivering Tax Credits effectively, which I have covered in Part 2 of this Report;
  - the action the Department is taking to improve the operation of PAYE, which I have examined in Part 3 of this Report;
  - the Department's management of Self Assessment, which I have dealt with in Part 4 of this Report; and
  - the Department's approach to the administration of Value Added Tax, which I have reported on in Part 5 of this document.
- carried out value for money studies under the National Audit Act 1983 that have contributed to my overall view of the Department's management of the tax systems, including reports on:
  - the Department's re-competition of its outsourced IT services, (HC 938, 2005-2006);
  - how the Department helps newly registered business meet their tax obligations (HC 98, 2006-2007);
  - filing of VAT and Company Tax returns (HC 102, 2006-2007);

- how the Department helps individuals understand and complete their tax forms (HC 452, 2006-2007); and
- the Department's accuracy in processing Income Tax (HC 605, session 2006-07).

- considered the Department's Statement on Internal Control (paragraphs 1.11 to 1.14 below) that provides a source of assurance about the quality of the Department's internal control framework;
- followed up on previous developments in areas that I covered in my Standard Report on the 2005-06 Trust Statement and Resource Accounts of HM Revenue & Customs; and
- taken into account the results of my audit of tax revenues, as set out in the separate Report I have appended to my audit certificate on the 2006-07 Trust Statement (pages 79 to 81).

Conclusion

1.4 Whilst recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, the National Audit Office's work in 2006-07 provided assurance that HM Revenue & Customs has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That assurance is subject to reservations about the level of claimant error and fraud in the award of tax credits (see Part 2 of this report). The report also includes observations on the collection of income tax through PAYE and Self Assessment and the administration of Value Added Tax.

Developments in the audit landscape

Modernising powers, deterrents and safeguards

1.5 The Government announced a formal review of the Department's powers, deterrents and safeguards following the creation of HM Revenue & Customs under the Commissioners for Revenue & Customs Act (CRCA) 2005. The aim is to design a framework of law and practice for the Department to support the Government's objectives of a tax system that is fair and better adapted to the needs of customers. In June 2005 a Consultative Committee was established, including tax experts, representatives of business and the legal and accountancy professions, to reflect the views of the wider taxpayer community. Following the publication of two general consultation documents[1] the Department has made progress in the following specific areas, all of which are subject to Parliamentary approval and Royal Assent:

- Criminal Investigation Powers – In August 2006 the Department published a technical consultation document seeking initial views on the statutory powers the Department needs for investigating serious tax crime. Following responses to that document, the Department consulted further over specific proposals for powers and safeguards, including draft legislation and explanatory material. This consultation closed on 13 March 2007. The Government has made proposals based on these consultations in the Finance Bill 2007.
- Surveillance Powers – The Government has included a clause in the Home Office Serious Crime Bill to extend surveillance powers, to apply to matters formerly the responsibility of Inland Revenue. These powers will be subject to the same controls and safeguards that are part of the surveillance powers the Department inherited from the former HM Customs & Excise.
- Civil Penalties - In December 2006 the Department issued a consultation document with draft legislation and explanatory material for civil penalties for incorrect returns. It sought views on proposals for a single structure for penalties for completing incorrect tax returns to apply to Income Tax, Corporation Tax, Capital Gains Tax, VAT and employers' PAYE and National Insurance Contributions. This consultation closed on 13 March 2007. The Government has included proposals based on this consultation in the Finance Bill 2007.

Carter Review of Online Services

1.6 In July 2005 the Paymaster General asked Lord Carter of Coles to advise on measures to increase the use of key online services. His review specifically looked at online services for Self Assessment, PAYE, VAT and Corporation Tax. Lord Carter's report was published on 22 March 2006 as part of Budget 2006, alongside the Government response accepting the recommendations. The recommendations included:

- requiring businesses to file their VAT returns, company tax returns and PAYE in-year forms online in phases from 2008;
- introducing new filing deadlines for Income Tax Self Assessment returns;

- promoting online filing by tax agents and better quality data by withdrawing computer-generated paper 'substitute' Self Assessment returns (for the 2007-08 and subsequent returns); and
- removing perceived barriers to early filing of Self Assessment and company tax returns by linking, for 2007-08 and subsequent years' returns, the period that the Department has to query a return to the date it is filed.

1.7 Following representation from tax agents that the proposed earlier filing dates for both paper and online Self Assessment returns would cause serious disruptions to their businesses, Lord Carter reviewed his findings. He made a revised recommendation that for 2007-08 and subsequent returns, the filing period for paper returns should be reduced to seven months, with a new deadline of 31 October. Lord Carter also recommended that for 2007-08 and subsequent years returns the filing period for online returns should remain at ten months with a deadline of 31 January.

1.8 After consultation with customers, in Budget 2007 the Government announced an extended timetable for implementation of the Carter recommendations. The Department still aims for universal electronic delivery of tax returns from businesses and computer literate individuals as Lord Carter recommended. It expects to deliver all the Carter recommendations for Self Assessment, PAYE, Corporation Tax and Value Added Tax, but this will now be a phased implementation. The extended timetable will give customers more time to prepare and the Department time to ensure that services are robust, and to build customer confidence in those services. The Department will also have the opportunity to further develop understanding of different customer needs, design services to meet those needs, and consider whether any special provisions are needed for particular groups. Parts 3 and 4 of my report examine in more detail the Department's provision of online services for PAYE and Self Assessment.

The Department's Transformation Programme

1.9 In Budget 2006, the Chancellor announced an early settlement of the Comprehensive Spending Review for the Department including access to a £300 million Modernisation Fund to assist the Department in its programme of investment. As part of that settlement the Department agreed to make efficiency savings of five per cent each year to 2011. As part of the Spending Review 2004 the Department is also committed to make £507 million savings by 2007-08, including a net reduction of 12,500 full time equivalent posts and relocating 1,950 posts by 2007-08 and 4,250 by 2009-10. A major challenge for the Department is maintaining "business as usual" whilst delivering these savings.

1.10 One of the conditions of the settlement is for the Department to agree with HM Treasury a plan that sets out spending proposals for the next five years. The Department has developed a five year plan, "the Five Year Ambition", aimed at delivering a more customer focused organisation, ensuring wilful non-compliance is detected and dealt with effectively and running costs reduced. In support of the Five Year Ambition the Department proposes to invest – through its Departmental Transformation Programme – approximately £1.9 billion in the period 2006-07 to 2010-11.

Statement on Internal Control

1.11 To meet his reporting responsibilities to Parliament, the Principal Accounting Officer has provided in pages 1 to 8 of the 2006-07 Accounts a Statement on Internal Control. The Statement serves two reporting purposes:

- to provide Parliament with assurance that the Accounting Officer has put in place the necessary control framework to manage risk. This is set out in paragraphs 2.1 to 5.7 of the Statement; and
- to give the Accounting Officer the opportunity to highlight to Parliament the areas of concern highlighted by his review of the effectiveness of internal control. These matters are described in paragraphs 6.1 to 6.23 of the Statement.

1.12 Principally as part of my audit of the Trust Statement and the Resource Accounts, my role with regard to the Statement on Internal Control is to consider whether the Accounting Officer's statement reflects the Department's compliance with HM Treasury's disclosure guidance. I report in my audit certificate if it does not. I also consider the Accounting Officer's Statement on Internal Control in reaching a conclusion about the adequacy of the systems for the assessment, collection and proper allocation of revenues brought to account by the Department. In doing so I consider whether the Statement properly reflects all material control weaknesses that have come to attention in my audit.

1.13 The Department has introduced an effective process for preparing its annual Statement on Internal Control. This involves a reporting process that ensures that each of its Executive Committee members prepares an individual internal control statement. The statements are underpinned by evidence reported from Directors. The Executive Committee then considers which control matters should be included in the Departmental Statement having weighed the relative importance and materiality of the control matters reported by individual members. The Department's Internal Audit also scrutinises the Statement on Internal Control, including analysis of the underlying material that is independent of the Executive Committee's own review procedures. The Department's Audit Committee also examines and challenges the Statement on Internal Control, drawing on both the Executive Committee's review process as well as Internal Audit's work.

1.14 The Statement on Internal Control for 2006-07 acknowledges that the Department faces a number of significant control weaknesses. My report considers some of these issues, namely tax credits (Part two), Pay as You Earn (Part three), Self Assessment (Part four) and VAT (Part five).

Managed service companies

1.15 Managed service companies are intermediary companies through which the services of a worker are provided to an end client. The tax treatment of the services provided is governed by the intermediaries legislation (also known as "IR35"). This looks at the relationship between the worker and the client to establish whether the contract means the worker is actually an employee of the client. Where this is the case, the intermediary company is required to pay employed levels of tax and National Insurance contributions on the income. Where this is not the case the intermediaries legislation does not apply and offers the opportunity for payment to be received in the form of dividends rather than salary. Routing income through an intermediary company to disguise employment enables the worker and end client to avoid paying employed levels of tax and National Insurance contributions.

1.16 The Department has evidence of a significant growth in managed service company schemes being used to avoid paying employed levels of tax and National Insurance contributions. The Department estimates that the number of individuals providing services through such schemes has increased from 65,000 in 2002-03 to 240,000 in 2005-06 and that there are now over 150 scheme providers. The Department has encountered difficulties in enforcing the IR35 legislation because of the large and growing number of workers involved. Furthermore, when a debt has been established as a result of an investigation, it has found that some managed service companies escape payment as they have few assets and can generally be wound up or cease to trade, with workers moving to new managed service companies.

1.17 The Government recently announced changes which are intended to address these problems. In Budget 2007, the Government announced it would remove Managed Service Companies from the scope of the Intermediaries legislation and individuals working in Managed Service Companies will pay tax and National Insurance contributions at the same level as other employees. The Government estimates that the changes will increase tax yield by £1.05 billion in the three tax years starting from 2007-08.

Corporation tax: film tax relief

Introduction

1.18 The Finance Act 2006 introduced new rules for the taxation of film production and in particular, a new tax relief for the production of British cinema films. The principal features of the new film tax relief are that:

- it is a relief that is available solely against Corporation Tax;
- it is only available to the company that actually produces the film;
- the film is made to be shown commercially in cinemas;
- the film must be certified as British, based on qualifying criteria that are predominantly cultural;
- at least 25 per cent of the eligible production expenditure should relate to film making that has taken place in the United Kingdom;
- a production company can claim film tax relief on a provisional basis, before a film is complete, provided that it has an interim certificate indicating that the film is culturally of a British nature; and
- the film tax relief includes a payable tax credit.

These new rules began on 1 January 2007 for films whose production companies began principal photography on or after that date; and for films where the production companies had started principal photography before 1 January 2007 but had not completed filming at that date.

1.19 Under these arrangements, the responsibility for administering the film tax relief is shared between HM Revenue & Customs, the Department for Culture, Media and Sport (DCMS) and the UK Film Council (UKFC), a non-departmental public body that is sponsored by the DCMS. The DCMS is responsible for issuing the certificates (both interim and final) that certify that a film is culturally British; and therefore potentially eligible for the tax relief. The DCMS administers the new "cultural test" through and on the advice of the UKFC. A film production company that receives a certificate from the DCMS may then apply to HM Revenue & Customs for film tax relief as part of its annual corporation tax return.

Historical context

1.20 Before the Finance Act 2006, tax relief was available for production and acquisition of British films under various sections of the Finance (No. 2) Act 1992, the Finance (No. 2) Act 1997 and the Income Tax (Trading and Other Income) Act 2005. In July 2005, HM Treasury published for consultation the results of a review that it had conducted on the film tax relief that was available under these legislative arrangements.[2] The review concluded that the tax reliefs were subject to a number of weaknesses, both operationally and in their fit with the Government's objective of encouraging stable and sustained investment in the production of culturally British films.

1.21 Operationally, HM Treasury was concerned at the extent to which the tax reliefs were subject to tax avoidance. The review highlighted that between 2000 and 2005, the Government had enacted in legislation no less than 13 anti-avoidance measures to protect the Exchequer against abuse of film tax incentives. The Treasury concluded that because of the high levels of avoidance, the existing reliefs were no longer an effective means of delivering the Government's objectives for the United Kingdom film industry. HM Treasury also identified other factors that contributed to this view:

- the tax reliefs were available for all eligible expenditure, irrespective of the country in which the costs were incurred, provided that the production met the certification criteria. In some instances, this meant that the extent of activity in the United Kingdom was low;
- tax avoidance had created a degree of undesirable market distortion. In particular, HM Treasury cited the production of poor quality products that had been made solely for the purpose of claiming accelerated tax relief;
- the extent of tax avoidance had also created uncertainty in the film industry, because it had resulted in higher levels of support than had been intended; and that in turn had generated uncertainty about the Government's commitment to provide continuing support; and
- the availability of the tax relief to film financiers (rather than solely to film producers) had proved an inefficient way of supporting the industry.

The Government enacted the new film tax relief rules in the Finance Act 2006. These rules are supported by statutory instruments and by specific guidance that is available to film production companies to help them apply the new provisions of the relief.

1.22 Companies and others involved in the production or financing of films that were completed before 1 January 2007 can claim tax relief under the rules in the Finance (No 2) Act 1992, the Finance (No 2) Act 1997 and Income Tax (Trading and Other Income) Act 2005 on eligible production expenditure, but only on acquisition expenditure incurred by 30 September 2007. There is a small category of productions that began filming before 1 January 2007, were not completed at that date and which do not satisfy the new cultural definition of a British film. These films can also qualify for relief under the old rules but with 31 March 2008 as the final date for acquisitions.

Costs to the Exchequer of the new film tax relief

1.23 The Regulatory Impact Assessment for the new tax relief, published alongside Budget 2006, indicates that the new relief was estimated to cost £20 million in 2006-07 and will cost £120 million a year thereafter.[3] The Department is not yet able to confirm an estimated cost for 2006-07 for the new relief, principally because it has only received a relatively small number of claims under the new relief. This is not unexpected, given that the regulatory framework to allow such claims to be made for films commencing principal photography before January 2007 under the new relief was not in place until March 2007. In addition, because of the retrospective way in which Corporation Tax works, where businesses are able to submit their annual tax returns up to twelve months after the end of their accounting period, the Department does not expect to have a reliable estimate for the 2006-07 cost of the relief until early in 2008-09.

1.24 The Department will capture the expenditure taken into account, and amounts claimed as payable, for film tax relief from the annual Company Tax return. The Department's principal IT System for managing Corporation Tax (the COTAX system) is currently not configured either to calculate or to identify the value of film tax relief claimed by film production companies as a deduction from tax, rather than as a payable credit. For monitoring purposes, the Department therefore plans to supplement the information on claims that is available on individual tax returns with data supplied by the offices that process the claims. The Department will collate this data centrally to provide an overall picture of the cost of this new tax incentive.

Operational characteristics of the new film tax relief

The relationship between HM Revenue & Customs and the Department for Culture, Media and Sport

1.25 Both the Department and DCMS recognise that the relationship between them will have to change to reflect the new rules that apply to film tax relief; and to reflect the roles that UKFC will play in supporting DCMS. The two Departments are currently developing a Memorandum of Understanding that will set out their respective roles for the various aspects of administering the film tax relief and in particular, the certification process. The Memorandum should provide a sufficient framework to ensure (amongst other things) that DCMS puts in place appropriate validation and quality assurance procedures around the certification process. The Memorandum will, where appropriate, also formalise the practices that have evolved under the old tax relief regime; as well as to clarify responsibilities where new rules apply.

1.26 The Memorandum of Understanding will also acknowledge that it is the Department that has overall responsibility for managing risk, simply because the ultimate risk to the Exchequer lies within the yield of Corporation Tax. However, both the Department and DCMS intend to maintain a joint risk register that they will review at regular monthly liaison meetings. Within this framework, each Department will be able to alert the other to new specific or generic risks. The Finance Act 2006 provides the Department with new powers to supply DCMS with information if its normal enquiry programme highlights a particular risk attached to an individual film.[4] For example, if the Department's enquiries suggest that a film does not meet the criteria for being a British film, then the Department can share this information with DCMS.

Claiming film tax relief

1.27 An important feature of the new film tax relief is that it is only available to film production companies, which are defined in the Finance Act 2006. Under this legislation there can be only one such company for any film. This should reduce the number of claims that the Department has to consider: for each film made, there will be a single production company and one claim for tax relief, based on a single certificate indicating that the film is culturally British. However, the new rules do allow a production company to claim for film tax relief on a provisional basis, before a film is complete, on the basis of an interim certificate issued by DCMS indicating that the film is culturally British. Where a company has asked for an interim certificate, it must also obtain a final certificate (on completion of the film) which will replace any interim certificates that it has received.

1.28 DCMS is responsible for issuing all certificates and will do so having taken advice from UKFC, where UKFC has considered whether a film qualifies as British. A film may be British where:

- it satisfies the "cultural test" provided for in Films Act 1985 (as amended);[5]
- it meets the terms of one of the United Kingdom's bilateral co-production treaties; or
- it meets the terms of the European Convention on Cinematographic Co-production.

DCMS will normally issue any interim certificates with a validity period of three years, although they may, at the request of the production company, be for longer periods. This may be necessary where a company undertakes a lengthy production such as an animation or a live action film, with a large amount of computer generated imagery. Under the former film tax relief arrangements, the certificates issued by DCMS had no expiry date. The introduction of expiry dates for the new certificates provides an element of control that was missing from the previous arrangements, though any certificates in circulation for the former relief will be useless for acquisitions made after 31 March 2008 (see paragraph 1.22).

1.29 The Department is putting in place processes and procedures with DCMS to monitor the issue of certificates so that it will be able to track applications for the tax relief. These arrangements include:

- receiving early notice of the production companies that have applied to DCMS and UKFC for certificates;
- receiving monthly information of films certified either on an interim or on a final basis as British. This information will allow the Department to:
  - allocate each case to the appropriate office for considering claims, since the monthly information will include the name of the production company as well as the name of the film; and
  - confirm, once the claim is received from the company, that DCMS did in fact issue any certificate that is supplied.

The Department is required to accept any certificate that is issued by DCMS. However, if the Department does have grounds from its enquiry work to suspect that a certificate was wrongly issued, then it can, under the Finance Act 2006, inform DCMS of this.[6] DCMS can then investigate these suspicions and where justified, revoke the certificate.[7] The Department is then able to treat any revoked certificate as never having been issued; and any tax relief obtained on the basis of it is withdrawn.[8]

Conclusion

1.30 The Finance Act 2006 introduced new rules for the taxation of film production and in particular, a new tax relief for the production of British cinema films. The Department, in collaboration with DCMS, has designed the new relief to try to avoid the possibilities of it becoming vulnerable to avoidance activity. The Department considers the fact that the relief may only be claimed by film production companies will help to mitigate this risk. The previous relief was open to companies and individuals whose involvement in film making was confined to providing or arranging finance. These groups are now excluded from the new arrangements.

1.31 The Department recognises that there are still residual tax avoidance risks, as individual companies may seek to push the boundaries of what may be categorised as qualifying expenditure for film production. As the Department receives claims for film tax relief it will start to construct a risk profile built around experience of dealing with compliance issues, rather than as at present, based on predictive analysis of behaviour. The Department will also assess the operation of the new film tax relief once it has been in place for at least a year. The Department considers that experience with similar policy measures suggests that the overall impact is only clear in the longer term.

1.32 Against this backdrop, it is important for the Department to ensure that:

- the Memorandum of Understanding between the Department and DCMS sets out clearly the respective roles of the two departments for management of the tax relief. In particular, the responsibilities that DCMS has for the certification process; and
- the processes and procedures that it puts in place to monitor the costs associated with the tax relief are sufficient to meet the commitment to do this under the Regulatory Impact Assessment.[9] The Department should also ensure that its management information systems are able to identify and aggregate the cost of this relief.

PART TWO

Tax Credits

Introduction

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

2.2 During 2006-07, the Department paid a net £18.7 billion in tax credits and an average of 5.5 million families received awards. The cost of administering the scheme was £587 million. **Figure 1** gives an overview of the tax credits scheme since its introduction in April 2003.

2.3 Child Tax Credit is designed to address the specific needs of families with children, and provides financial support based on the number of children and any disabilities they may have. It is available to those aged 16 or over, whether working or not, who are responsible for at least one child. Working Tax Credit is intended to support working people, both employed and self employed, by topping-up earnings; the amount depends on factors such as age and/or the number of hours worked. Additional support is available for eligible childcare costs or where a member of the household suffers from disability.

1 Tax Credits: Scheme Overview

		2003-04	2004-05	2005-06	2006-07 provisional[2]
Families benefiting[1]		4.6m	5.0m	5.3m	5.5m
Of which:	Child Tax Credit	4.4m	4.8m	5.0m	5.2m
	Working Tax Credit	1.6m	1.7m	1.8m	1.9m
Net cash paid to claimants in year		£13.5bn	£15.8bn	£17.3bn	£18.7bn
Final value of awards[3]		£12.0bn	£14.3bn	£16.0bn	Not yet known
Administrative cost[4]		£406m	£475m	£467m	£587m
Staff employed by the Department		7,300	8,200	8,750	10,120

Source: HM Revenue & Customs

NOTES

1 Figures represent the average number of families benefiting in the year for 2003-04, 2004-05 and 2005-06 in finalised awards and for 2006-07 in provisional awards. Some families benefit from both Child and Working Tax Credits.

2 Actual information for 2006-07 will be available in May 2008, after awards have been finalised.

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

4 Administrative costs have increased from 2005-06 to 2006-07 because of an increase in staff costs, and a change in the Department's approach to overhead apportionment following the introduction of new financial systems.

2.4 My recent Standard Reports have covered a number of important issues in the administration of tax credits, including overpayments and their recovery, high levels of error and fraud and attacks on the system by organised criminals. As part of my work in 2006-07 I have examined the progress the Department has made in dealing with these issues and my report covers:

- overpayments and underpayments caused by adjustments to awards;
- recovery of overpayments;
- claimant error and fraud; and
- the service provided to tax credit claimants.

Overpayments and underpayments caused by adjustments to awards

2.5 The amount of tax credits paid is based on an annual entitlement. The Department calculates a provisional award and makes payment using the latest information it holds about the claimant. For 2005-06 awards, claimants had until 31 August 2006 to confirm their actual circumstances and income. The Department used this information to make an assessment of the final award and, where it was renewed, establish a provisional award for 2006-07. In some cases the final award differed from the provisional award, for example where the final income was different from the figure used to calculate provisional awards. The Department paid the claimant a lump sum where it calculated that the provisional award resulted in an underpayment. Where the provisional award resulted in an overpayment, the Department is seeking to recover it from future awards or, if there is no ongoing entitlement, directly from the claimant. An overview of the timetable for the calculation and payment of awards is given in **Figure 2**.

2.6 In 2005-06 overpayments were £1.7 billion, as shown in **Figure 3**. In accordance with the Department's normal approach, this figure is net of remissions and recoveries of overpayments made before the end of the year. Tax Credit awards for 2006-07 are not all due to be finalised until the end of January 2008. The Department will publish overpayment statistics on these awards in May 2008.

2.7 Overpayments in 2005-06 included £378 million relating to some 254,000 terminated awards for 2004-05. The Department terminated awards if claimants failed to report their actual incomes and circumstances for 2004-05 in order to finalise and renew their award by 30 September 2005, failed to return a signed award notice for 2005-06, or were found not to qualify for tax credits. Terminated awards can be reinstated where claimants have had a reasonable explanation for failing to confirm their income and circumstances in the renewal window.

2 Timetable for the calculation and payment of 2006-2007 awards

2005-06	Claimants' prior year income is used as the initial basis for 2006-07 provisional payments.
2006-07	Provisional payments made for 2006-07 awards.
	Claimants may notify HMRC of changes in circumstances. HMRC will then calculate a revised award and amend payments to reflect the latest information.
2007-08 April-July	The claimant informs HMRC of their actual circumstances and income for the previous year.
	HMRC finalises the award and seeks recovery of overpayments and pays underpayments as a lump sum.

Source: National Audit Office

3 Tax Credits Overpayments and Underpayments to 31 March 2006

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

Source: HM Revenue & Customs

NOTES

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

2 Figures may not sum due to rounding.

2.8 The Department has examined a sample of the 228,000 awards terminated in 2004-05 to improve its understanding of claimant behaviour. The Department estimates that some 180,000 of the awards terminated were due to the claimant's failure to report their actual 2003-04 incomes, although of these 22,000 new awards were subsequently made to the same claimants before the year end. But there was insufficient evidence to conclude why the remaining claimants had not finalised their awards. The Department is now undertaking a more comprehensive exercise to examine why claimants fail to finalise their awards.

2.9 To limit the need for adjustments to provisional awards, the Department disregards certain rises in the claimant's income during the previous year when it finalises awards. This level was initially set at £2,500 and the Department estimates that final entitlements to tax credits in 2005-06 would have been around £700 million lower without this disregard.

2.10 The 2005 Pre-Budget Report announced changes which were designed to provide greater certainty to claimants, particularly when claimants see a rise in income. The principal measures are:

- for awards for 2006-07 and subsequent years, the level at which increases in income are disregarded when finalising awards has been raised from £2,500 to £25,000. The Department estimates that the impact of this measure alone would reduce overpayments by £400-£600 million. The cost to the Exchequer of this change is the foregone recovery of these overpayments;
- from April 2006, place additional responsibilities on claimants to notify the Department promptly of changes in circumstances in-year that affect their awards;
- for awards from 2005-06, bring forward the date by which claimants have to finalise their awards;
- introduce automatic limits on the recovery of overpayments where awards are adjusted in-year following a reported change in circumstance, with the aim of encouraging more families to report in-year changes of circumstances; and
- increase payments only for the remainder of the year when claimants report a fall in income during the year; with a further payment if appropriate when the award is finalised after the end of the year.

2.11 The Department will publish details on finalised 2006-07 awards in May 2008 which will provide more information on the effect of these measures. When fully implemented the Department anticipates that the package as a whole will reduce the value of overpayments by a third. The Department's latest information – based on its in-year monitoring of payments and entitlement arising from changes of circumstances – indicates that the measures should deliver this reduction.

Recovery of overpayments

2.12 The Department's approach to recovering overpayments is set out in its guidance to claimants.[10] Where there is on-going entitlement, it recovers overpayments from future tax credit payments. But the Department restricts recoveries made against the payment of future awards to prevent hardship. It seeks direct recovery of overpayments where the claim is no longer in payment and considers requests to pay by instalments. The Department expects complete recovery of overpayments to take several years.

2.13 At the end of March 2007, £3.9 billion was owed to the Department in respect of overpayments.[11] Of this debt, £1.7 billion was being recovered from ongoing awards and £1.5 billion directly from claimants. In addition, some £700 million of debt was not yet subject to active recovery action, for example because the Department had not or had only recently issued a notice to pay, ceased awards where the award had not been finalised, or the claimants' appeal periods had not yet expired.

Recovery of overpayments from ongoing awards

2.14 Over the first four years of the scheme the Department has recovered £1.6 billion of overpayments from ongoing tax credit awards. It is seeking to collect a further £1.7 billion against future payments. Some of these overpayments may later be subject to direct recovery if the award ceases, for example because of family break-up or if the youngest child leaves full time education.

2.15 The Department restricts recoveries made against the payment of future awards where it considers this would cause hardship and the maximum it recovers each year is:

- 10 per cent from claimants entitled to the maximum award;
- 25 per cent for those entitled to more than the family element of Child Tax Credit, or less than the maximum Working Tax Credit; and
- 100 per cent for those entitled to only the family element of Child Tax Credit.

2.16 Since the introduction of tax credits, the Government has made changes to how overpayments are recovered. Originally, where claimants notified the Department of changes in circumstances within the year which gave rise to an overpayment, it aimed to recover the overpayment in full before the end of that year. This contrasted with the treatment of changes in circumstances notified after the year end, where claimants were given longer to repay.

2.17 The 2005 Pre Budget Report announced the introduction of automatic limits on the recovery of overpayments where awards are adjusted in-year following a reported change in circumstance. The Department originally intended to introduce this change in November 2006. Automating this process involves significant changes to the tax credits computer system. After testing, the Department concluded that making the changes as initially intended would have raised an unacceptable level of risk of incorrect payments. The Department introduced interim manual arrangements to limit rates of recovery when contacted by claimants and some 5,000 claimants had their claims adjusted under these arrangements. In January 2007, the Department introduced an enhanced process to identify cases where recovery limits should apply, which meant the claimant did not have to request this and in the period January to March 2007 52,000 awards were automatically adjusted by this process. The Department expects an automated process to be in place in the summer of 2007.

Direct recovery of overpayments

2.18 Since the introduction of tax credits, the Department's debt management teams have been passed £1.9 billion of debt to recover. By the end of 2006-07, they had collected £0.4 billion and £1.5 billion was outstanding. The Department accepts payments by instalments over 12 months and considers requests to pay over a longer period. It has agreed 535,000 arrangements for overpayments to be repaid this way.

2.19 Tax Credit awards for 2003-04 were not all finalised until the end of January 2005. It was only once this process had been completed that direct recovery of debt could fully commence. But the Department experienced difficulties transferring information on debt from the tax credits computer system to the system used for debt management. The direct recovery of debt has been affected by the backlog of work that was created.

Write-offs and provisions for bad debt

2.20 The Department has to form a view on the tax credit debt that may not be recovered and may eventually be written off. In the first three years of the scheme, it has written off £0.7 billion of the £6.0 billion debt to be recovered shown in **Figure 4**. It has also written off £0.2 billion in respect of amounts paid and written off in the same year, before awards were finalised, for example where it has identified organised fraud. In addition, a total provision of £1.6 billion has been made in the Trust Statement account for doubtful debt. An analysis of amounts written-off and amounts to be recovered is given in Figure 4.

4 Recovery and write-offs of overpayments from 2003-04 – 2005-06

	2003-04	2004-05	2005-06	Total
Overpayments[1]	£2.2bn	£1.8bn	£1.7bn	£5.8bn
Subsequent adjustments to entitlement[2]	£0.1bn	£0.1bn	–	£0.2bn
Total to be recovered	£2.3bn	£2.0bn	£1.7bn	£6.0bn
Amounts written off by 5 April 2007	(£0.4bn)	(£0.3bn)	(£0.1bn)	(£0.7bn)
Amounts recovered by 5 April 2007	(£1.1bn)	(£0.6bn)	(£0.3bn)	(£2.0bn)
Debt to be recovered at 5 April 2007	£0.9bn	£1.1bn	£1.3bn	£3.3bn

Source: HM Revenue & Customs

NOTES

1 This table excludes amounts for 2006-07 awards. The overall level of overpayments for these awards will not be known until they have been finalised. Figures may not sum due to rounding.

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

2.21 In 2006-07 the Department has written off £369 million. Around half of the total amount written off relates to £300 million overpayments made to claimants in the first four years of the scheme who failed to notify the Department they had stopped work, but continued to receive Working tax credits. Some of these individuals should have instead claimed Income Support or Jobseekers Allowance. The Department has reviewed the extent to which these overpayments can be recovered and concluded that it would not be cost effective to recover £186 million, and this has been written off in 2006-07. The Department is seeking to recover the remaining overpayments.

2.22 In 2006-07 the Department also wrote off £61 million in respect of official error, £40 million in respect of Organised Fraud and £37 million in respect of duplicate payments made in 2003-04. The remaining write offs include small overpayments the Department considered were not cost effective to pursue, overpayments where recovery would cause hardship to claimants, and debt that the Department considers is irrecoverable for various other reasons.

Claimant error and fraud

Compliance checks performed on tax credit awards

2.23 The Department tries to maintain a balance between ensuring the accessibility of the scheme to claimants and maintaining safeguards against the risk of error and fraud. It aims to achieve this by investigating claims which it judges present the highest risk and checks these before or, in certain cases after, claims are paid. In July 2006, it published "Tackling Error and Fraud in the Child and Working Tax Credits" which set out its plans for tackling claimant error and fraud. This included strategies to reduce customer error by improving communications to make them easier to understand, and improving the quality of advice and processing work undertaken by contact centres. Strategies to tackle fraud included further developing risk assessment procedures, embedding compliance specialists in contact centres and working with other Government Departments and the private sector to combat identify fraud.

The Department's compliance checks

2.24 **Figure 5** provides details of the volume and effectiveness of the Department's direct compliance checks. In 2006-07, its compliance teams carried out 137,930 pre and post payment checks on the highest risk claims, which identified incorrect payments of £148 million and prevented incorrect payments of £138 million.

2.25 Since April 2005, the Department has increased the number of checks undertaken before awards are paid, which is the most cost effective way to avoid financial loss. During 2006-07 it performed 41 per cent of its compliance checks on claims before they were paid. These checks are important in correcting errors before claims start to be paid, providing customer education and demonstrating visible compliance activity. The Department also performs compliance checks on claims that are being paid. This aims to target high risk claims in payment and counter paper based attacks on the system, the method which the Department found fraudsters resorted to following the closure of the tax credits internet site.

5 HMRC's direct compliance checks

	2004-05	2005-06	2006-07
Volume of Checks			
Target	101,500	110,000	130,000
Actual checks	107, 789	146,376	137,930
Pre payment: post payment ratio	16%:84%	45%:55%	41%:59%
Effectiveness of checks			
Actual Yield[1], comprising:	£130m[2]	£528m	£286m
Incorrect payments prevented[3]		£307m	£138m
Incorrect payments found[4]		£221m	£148m
Checks resulting in change to award:			
Pre award	93%	93%	68%
Post award	65%	85%	81%

Source: HM Revenue & Customs

NOTES

1 The Department does not generally set a target for yield.

2 The Department did not record information on the composition of yield in 2004-05.

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

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

2.26 In addition to direct checks by tax credit compliance teams, the Department may act in other ways to identify fraud and withhold tax credits payments. This can be either as a result of the work of its criminal investigation teams or through other procedures, such as inspecting claim forms prior to processing for evidence of organised fraud. **Figure 6** provides an analysis of the outcomes arising from all of its actions in 2006-07 to stop erroneous and fraudulent tax credit claims. The Department estimates that in 2006-07 it prevented incorrect payments of £291 million; this comprises £233 million from checks on claims before they were paid and £58 million from checks on awards in payment. The Department's checks of awards in payment also found it had made incorrect payments of £151 million, including £40 million of suspected organised fraud. The fall in levels of suspected organised fraud from 2005-06 is primarily due to fewer attacks following the closure of the tax credit internet site in December 2005. The Department is developing a framework for validating the identity of individuals and will only re-open the internet system once this work is complete, which is unlikely to be before July 2008.

6 Outcome of all HMRC compliance and other actions on tax credits fraud and error cases in 2006-07 (2005-06 figure in brackets)

	Individual error and fraud £m	Suspected Organised Fraud £m	Total £m
Checks before claims entered into payment			
Incorrect payments prevented[1]	61 (19)	172 (313)	233 (332)
Checks on awards in payment			
Incorrect payments presented[1]	18 (19)	40 (96)	58 (115)
Incorrect payments found[2]	111 (119)	40 (131)	151 (250)
Total	**190 (157)**	**252 (540)**	**442 (697)**

Source: HM Revenue & Customs

NOTES

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

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

2.27 The Department is looking to broaden the range of its compliance work to encourage tax credits claimants to comply with their obligations. It is considering how it can apply a broader range of compliance actions to improve compliance across the wider tax credit population, in addition to focusing its actions on those it assesses as high risk. This builds on its experience of compliance elsewhere in the Department. If successful, this will allow it to offer support and advice to a much larger number of claimants, improving customer service and potentially reducing levels of claimant error and fraud.

2.28 If an enquiry uncovers evidence of non-compliance, the Department's next step is to determine appropriate sanctions and recover the amounts owed (including any charges and penalties imposed). As shown in **Figure 7**, a relatively small number of cases are selected for criminal prosecution. The Department limits its use of criminal prosecution to the more serious cases of tax credits fraud and those involving organised attacks on the system.

Overall levels of claimant error and fraud

2.29 The Department measures the overall level of error and fraud by investigating a random sample of finalised awards, although the design of the tax credits scheme affects the speed with which it can complete this work. Some claimants, such as those taxpayers included within Self Assessment, may not finalise their awards for the preceding year until 31 January. The Department may therefore not have been able to start its investigation of some 2004-05 awards until February 2006.

2.30 In June 2007, the Department completed its testing of 2004-05 awards, based on 4,500 random enquiries. As a result of this, the Department estimates that claimant error and fraud resulted in between £1.04 billion to £1.30 billion (7.3 to 9.1 per cent of the final value of awards) being paid to claimants to which they were not entitled.[12] The levels in 2003-04 were £1.06 billion to £1.28 billion (8.8 to 10.6 per cent). It also estimates

7 Tax Credits Sanctions

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

Source: HM Revenue & Customs

that claimant error resulted in between £200 million to £350 million (1.4 to 2.4 per cent) not being paid to claimants to which they were entitled. The levels in 2003-04 were £190 million to £280 million (1.6 to 2.3 per cent). As separately noted in my report on the 2006-07 Trust Statement, I concluded that this level was unacceptably high and, whilst the Department has made changes to its compliance procedures since 2004-05, there is currently no evidence to demonstrate a lower estimate for 2006-07. I have therefore qualified my opinion on the regularity of the expenditure reported in the Trust Statement in respect of tax credits claimant error and fraud.

2.31 In my 2006 Report, I noted that the Department was taking steps to improve the quality of its work in conducting these enquiries. These included providing additional guidance to compliance staff, performing greater management checks, closer working with teams undertaking Self Assessment enquiries and coaching individual staff to improve the quality of work on specific cases. My staff examined a sample of 2004-05 random enquires and found that these changes had not led to the anticipated improvement in the quality of enquiry work. The Department is now considering what further action it can take to enhance this work, including using specialist teams.

2.32 The Department is also working on plans to prepare more timely estimates of error and fraud, in addition to its work on finalised awards. It is examining how it can obtain early indicators of attempted error and fraud, for example by deriving an estimate from its compliance work on new claims. It is also considering how it can speed up its work on the random examination of awards.

2.33 Towards the end of 2006, the Department commenced a reorganisation of its compliance teams, by transferring more work to large centralised teams, supported by a reduced number of local teams based around the UK. The Department considers that increased centralisation of this work will increase its effectiveness at identifying claimant fraud and error. The reorganisation was nearing completion at the time of my report.

Ensuring that claimants meet the residency criteria for tax credits

2.34 To be eligible for tax credits, claimants need to be present and ordinarily resident in the United Kingdom (UK). Individuals are responsible for notifying the Department if they leave the UK for more than eight weeks. There are no means by which the Department can monitor whether claimants have in fact left the country. The Department has the power to charge penalties where claimants do not notify of such changes in circumstances, although it has not yet charged any such penalties.

2.35 Some concerns have been expressed that migrant workers are incorrectly claiming awards because they do not meet the residency criteria for tax credits. On 1 May 2004, 10 new countries joined the European Union (EU) and many people from those countries entered the UK to work. Migrant workers have to fulfil the same criteria as UK nationals to qualify for tax credits, which are set out in **Figure 8**. The Department performs pre and post payment checks to look for possible fraud and error, but these are made on all claimant applications, irrespective of nationality. The Department does not request information on nationality because it is not a condition for entitlement to tax credits. The Department's legal advice is that it is unlawful

8 Eligbility criteria for tax credits

A claimant must be both present and ordinarily resident in the UK throughout the period of the award. A person is considered ordinarily resident if they normally live in the UK (apart from temporary or occasional absences[1]) and have chosen to live and settle in the UK for the time being. A person can be ordinarily resident in more than one country and the fact that a person might be said to have a home in another country does not mean that they cannot also be ordinarily resident in the UK.

For new claims on or after 1 May 2004 for Child Tax Credit a person must also have a **'right to reside'** in the UK. The Department considers that the following groups are among those with a right to reside in the UK.

- All European Economic Area (EEA) Nationals legally working in the UK, including A8 nationals who are required to register their employment with the Workers Registration Scheme and have done so.
- Nationals of the A8 countries who are seeking work in the UK and have sufficient resources above the level of Income Support.
- EEA nationals, including nationals of the A8 countries, who are economically inactive and have sufficient resources above the level of Income Support.

Source: HM Revenue & Customs

NOTE

1 Absences of up to eight, or in certain cases 12, weeks may be discounted.

to target members of particular national groups unless it has identified a significant risk to the Exchequer from those nationalities which is not shared by other nationalities. The Department has told me that it continues to evaluate the extent of the risk.

2.36 In the light of these concerns, in 2006-07 the Department carried out a pilot exercise in conjunction with its Employer Compliance teams looking at an agency employing skilled labourers, to help it understand whether there are any particular risks with claims from agency workers. This exercise identified risks of non-compliance such as failure to notify the Department of reductions in hours worked. But the Department considers this is a risk with all claimants and not just in relation to agency workers. At the time of my report the Department was undertaking another pilot exercise to assess the level of specific risks which it expects to complete in August 2007.

The service provided to tax credit claimants

2.37 The Department has experienced problems with the service provided to claimants following the introduction of tax credits and has taken steps in the first four years of the scheme to improve the quality of service provided. These have included developing the tax credits computer system to improve the accuracy of processing and the quality of award notices, a series of measures announced by the Paymaster General in May 2005 to improve customer service and the development of revised procedures for handling complaints.

Developing the tax credits computer system

2.38 There were difficulties with the tax credits computer system following its implementation in 2003 and unforeseen overpayments due to software errors. The Department has recovered significantly from these problems. Since the initial implementation of the system, it has had a regular programme of enhancements (software releases) to the tax credits computer system, set out in **Figure 9**. The initial focus of the software releases was to allow the Department to process new awards, make payments and renew awards. Subsequent software releases focused more on improving the service provided to claimants, for example by improving the information provided to claimants.

2.39 The Department has an ongoing programme of prioritising and correcting software errors. In October 2005, it undertook an analysis of the tax credits computer system and identified 199 software errors which potentially cause underpayments and overpayments. The Department found that 63 of these had a high impact in that large numbers of households were affected by each problem and/or the resultant underpayments or overpayments were of high value. Of the 63 errors, 35 caused overpayments of £102 million and underpayments of £106 million, affecting 215,000 claimants. The Department could not quantify the effect of the remaining 28 in terms of the number of claimants and amounts involved prior to correcting the software errors and recalculating entitlement. The Department made enhancements to the computer system in October 2006, which included changes to increase its ability to detect and correct incidents before they affect claimants. At the time of my report, the Department was updating its quantification of the effect of software errors, although it has identified certain errors that continued to affect payments in 2006-07.

i In May 2006, a software error resulted in overpayments of £24.6 million. This was an unintended effect of changes made to the tax credits system in that month. The Department corrected the computer system and wrote to the claimants informing them that the overpayment would either be recovered from future payments or that they could repay it directly to the Department.

ii The Department has encountered difficulties in finalising awards for some claimants.
In 2005-06, the computer system was unable to finalise approximately 70,000 awards and the Department manually issued renewal notices where appropriate. The Department is examining what computer changes are needed and is making daily updates to the computer system in the meantime.

iii There continued to be some software problems that prevented the Department from making automated payment for a minority of claimants. At 31 March 2007 around 45,000 claimants were not receiving automated payments. A number of these were affected by a specific problem which the Department corrected in April 2007. At the end of April 2007 around 18,000 claimants were not receiving automated payment.

9 Timetable and content of Tax Credit system releases

Release	Content	Delivery Date
One	Provision of the basic process for claims and awards to be processed.	October 2002
Two	This allowed payments to be made to claimants and to process changes in circumstances and income: it also provided facilities for accounting and payment reconciliations.	April 2003
Three	Preparation for the renewals process	November 2003
	Support for the Department's compliance activity	November 2003
	Provision of Management Information	Part delivered
Four	Main system to support the process for the finalisation and renewal of awards. Further support for compliance activity. Initial support for debt management.	April 2004
Five	Remaining elements of the system to complete the October 2004 renewals process.	September 2004
	Additional support for debt management.	
Six	Support for an amended renewals process.	April 2005
	Amendments to the claim form, the award notice and the renewal notice.	
	Restriction in the rate of recovery of overpayments where full recovery would cause hardship.	
	Recovery of current year overpayments from the provisional payments for the following year.	June 2005
	Support for improved internal accounting.	
Seven	Improved matching of data between the Tax Credits and Child Benefit system to improve the accuracy of payment.	November 2005
	Provision of automated daily check of payments made against payments authorised.	
Eight	A redesigned award notice providing a detailed breakdown of how awards are calculated	April 2006
	Increase in the level of in-year income disregard to £25,000	
	Reduction in the period for renewing awards from six to five months	
Nine	Production of new award and renewal notices	October 2006
	Improvements to IT processes to improve system resilience	
	Improved information to support the bank reconciliation process.	
	Provision of full playback of all changes that have affected the award on the renewals notice.	

Source: HM Revenue & Customs

Processing accuracy

2.40 The Department has a target to decide accurately 95 per cent of new claims, renewed awards and changes of circumstances. As shown in **Figure 10,** the Department has made significant improvements against its target since the introduction of tax credits. This target reflects whether the information has been correctly entered on the tax credits system, but does not measure if the actual payment made was correct. The Department is now designing a new check which aims to establish if it is paying the right money to the right people at the right time. The Department will be collecting this information as part of its 2007-08 checks.

10 Accuracy of processing tax credit awards

	2003-04 %	2004-05 %	2005-06 %	2006-07 %
Target	90.0	90.0	95.0	95.0
Actual	78.6	96.5	97.9	96.8 (provisional)

Source: HM Revenue & Customs

2.41 The results do not attempt to capture the extent to which official error causes incorrect payments. In 2007, the Department undertook an exercise to measure the level of official error, involving an examination of a small sample of cases where a claimant had raised a dispute with the Department regarding an overpayment of tax credits. This indicated that official error occurred in about five per cent of disputed overpayment cases. The Department has been collecting this information on a routine basis since April 2007. It is also considering other ways of improving the information it makes available on official error.

The Paymaster General's Improvements

2.42 On 26 May 2005, the Paymaster General (PMG) announced steps to improve the Tax Credits system. The Department considers that it has now delivered these commitments and **Figure 11** sets out the action taken.

2.43 The Department is working on an improved business design to deliver tax credits in the future. This now forms part of the Department's Transformation Programme. It aims to deliver a tax credit service which is clearly understood and trusted by customers, so that they can rely on it to support them in raising their children and returning to work. It is also aligning that delivery with Child Benefit where appropriate. The Department also aims to ensure the right customers receive the right money at the right time, through a range of services and communications that is tailored to meet their individual needs and circumstances.

2.44 The Department has started to tailor the service it offers to claimants to suit different circumstances and is piloting new arrangements over the next few months. It has already piloted a Service Improvement Module focusing on the needs of those who need to make a new claim following the breakdown of the household which ended an earlier joint award. A second pilot involved proactive questioning to gather details of changes in circumstance to ensure the Department is advised of all the relevant facts.

11 Status of PMG's May 2005 improvements

Commitment	Action taken
Review the effectiveness of information provided to claimants, and to reduce the number of cases where people receive unnecessary duplication of award notices.	Improved award notices introduced from April 2006 with shorter, clearer guidance. The Department has reduced the unnecessary issue of award notices, for example award notices are no longer issued following notification of a change of address. The Department has improved the information contained in renewal notices to allow claimants to check the changes made in the period of the award.
Test new methods of reminding claimants of the importance of providing up to date in year information on changes in income and circumstances.	Messages added to queuing mechanism, reminding claimants which Changes of Circumstances should be reported. The Department has sent targeted mail shots to claimants' most likely to have had a change in their circumstances.
Develop options to improve the quality of the helpline service.	From early 2006-07 improved helpline scripts and improved training of helpline staff. The Department has empowered staff to take more action on cases and piloted a number of improvements in this area.
Identify IT system problems and processing errors more quickly.	Review in October 2005 of all known outstanding software problems impacting payments. Release 9 (October 2006) included changes to increase the ability to detect and correct incidents before they impact customers.
Developing innovative ways of working with the voluntary sector to target more active support on vulnerable families.	The Department established about a dozen task forces involving members of the voluntary sector. These addressed a range of issues, such as appeals, award notices, backdating of awards, its Code of Practice on recovering overpayments (CoP 26), the tax credits website, complaints and redress etc. In addition, the Department began work with Citizens Advice Bureau on a pilot exercise involving a trial of taking new tax credit claims by phone. A workshop was also held in February 2007 to identify areas of difficulty caused by the tax credit system for intermediary organizations, and to begin the process of addressing those problems.
Review the operation of the Code of Practice on overpayments, so that recovery can be suspended in cases of genuine hardship, while a disputed overpayment is resolved.	A Revised Code of Practice was published in April 2006, which included clarification of what is meant by 'reasonable belief'. The Department now suspends the recovery of overpayments while the dispute is resolved.

Source: HM Revenue & Customs

Handling complaints and disputed overpayments

2.45 The Department has established procedures for handling complaints, which are set out in its fact sheet: 'Complaints and putting things right". It distinguishes between complaints and disputed overpayments.

Complaints

2.46 Claimants can make complaints to the Department about the service provided. If claimants are unhappy with the Department's initial decisions they can ask it to review their case again. If claimants are unhappy with the way the Department has handled their complaint, they can ask the Adjudicator to review their case. Claimants can also refer their case to the Parliamentary and Health Service Ombudsman (the Ombudsman). **Figure 12** shows the number of complaints made to the Tax Credits Office since 2004-05.

2.47 The Department's Tax Credit Office received complaints in 54,483 cases in 2006-07. Although this represents 55 per cent of all the complaints received in the Department, it is less than one per cent of all tax credit claimants. The Department estimates that 75 per cent of tax credit complaints in 2006-07 relate to its decision on disputed overpayments. The second largest category of complaints received related to delays.

Disputed Overpayments

2.48 The Department has separate procedures to deal with disputed overpayments. The Department's policy is that the claimant should not have to pay back all or part of an overpayment due to a mistake by the Department if it was reasonable for the claimant to think the award was right. **Figure 13** provides details of disputed overpayments received since the Department began to recover overpayments in 2004-05. The Department introduced streamlined procedures during part of 2005-06 to deal with disputes against the recovery of overpayments on the grounds of official error. These led to the increase in overpayments written off in that year.

2.49 The Department aims to deal with disputed overpayments within four weeks. At the end of 2006-07 it had 46,000 disputed overpayment cases on hand.

12 Complaints made to the Tax Credit Office

	2004-05	2005-06	2006-07
Complaints made	47,921	62,686	54,483

Source: HM Revenue & Customs

The Adjudicator and the Ombudsman

2.50 The Adjudicator is an independent person who considers routinely whether or not the Department has applied its discretion appropriately when investigating cases of complaints and redress. In 2006-07 the Adjudicator found wholly or partly in the claimants' favour in 56 per cent of the tax credit investigations completed (74 per cent in 2005-06), as shown in **Figure 14** .

2.51 The Ombudsman continued to receive a large number of complaints about the administration of the tax credit system in 2006-07, and complaints relating to tax credits constituted a large proportion of her work. At the beginning of the 2006-07 year the Ombudsman decided that the Department's complaint handling processing had improved sufficiently to allow her to set up new arrangements for handling tax credit complaints. From April 2006, therefore, she decided to investigate only those complaints that had exhausted the Department's complaints procedure (including a referral to the Adjudicator's Office), those which raised new issues that needed exploring, or cases where other issues made it inappropriate to refer them back to the Department. As a result, she accepted fewer cases for investigation in 2006-07 than in the previous year (120 compared with 404). During the year she reported on 393 cases, some of which had been accepted in previous years, and referred 330 complaints back to the Department under the new arrangements. The proportion of tax credits cases fully or partly upheld reduced slightly from the previous year (74 per cent compared to 90 per cent) although this still remained higher than for other Parliamentary complaints investigated by the Ombudsman (58 per cent fully or partly upheld).

13 Disputed Overpayments

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

Source: HM Revenue & Customs

14 Outcome of complaints made to the Adjudicator on tax credits

	2003-04	2004-05	2005-06	2006-07
Complaints made	24	195	569	1,774
Percentage upheld	75%	86%	74%	56%

Source: Annual Reports of the Adjudicator 2004, 2005, 2006 and 2007

Conclusions

2.52 During 2006-07 the Department paid a net £18.7 billion in tax credits and an average of 5.5 million families received provisional 2006-07 awards. The Department estimates that year end adjustments to awards meant it overpaid £1.7 billion and underpaid £549 million in 2005-06. In the first three years since the scheme was introduced, the Department calculates that these adjustments, and other small changes to entitlement after the finalisation of awards, have led to a debt of £6.0 billion. It has also identified £600 million from in year adjustments to 2006-07 awards and will identify further overpayments for this year once awards are finalised. By the end of March 2007 the Department had collected £2.0 billion of this debt and written off £0.7 billion. £3.9 billion of overpayments remain to be collected by the Department. It has provided for £1.6 billion in respect of doubtful debts.

2.53 In the 2005 Pre-Budget Report the Chancellor announced a number of measures which were designed to provide greater certainty to claimants, particularly when families see a rise in income. One important change, for awards for 2006-07 and subsequent years, is the increase from £2,500 to £25,000 of rises in income which are disregarded when finalising awards. The Department estimates that this alone will reduce overpayments by between £400 million – £600 million per annum. The effect of the other changes is harder to establish as they seek to influence claimants' behaviour by encouraging the prompter reporting of changes in circumstances. The Department estimates that the changes together will eventually reduce the value of overpayments by one third. It will publish details on finalised 2006-07 awards in May 2008 which will provide more information on the effect of these measures.

2.54 The Department terminates an award if the claimant does not report their actual income, fails to return a signed award notice or did not qualify for tax credits. The Department has examined a sample of the 228,000 awards terminated in 2004-05 to improve its understanding of claimant behaviour. The Department estimates that some 180,000 of the awards terminated in 2004-05 were due to the claimant's failure to report their actual 2003-04 incomes, although of these 22,000 new awards were subsequently made to the same claimants before the year end. But there was insufficient evidence to conclude why the remaining claimants had not finalised their awards. In the absence of this information it is not possible to discount the risk that some of these claims were fraudulent. The Department is now undertaking a more comprehensive exercise to examine why claimants fail to finalise their awards.

2.55 In June 2007, the Department completed its testing of 2004-05 awards, based on 4,500 random enquiries. As a result of this, the Department estimates that claimant error and fraud resulted in between £1.04 billion to £1.30 billion (7.3 to 9.1 per cent of the final value of awards) being paid to claimants to which they were not entitled. The levels in 2003-04 were £1.06 billion to £1.28 billion (8.8 to 10.6 per cent). It also estimates that claimant error resulted in between £200 million to £350 million (1.4 to 2.4 per cent) not being paid to claimants to which they were entitled. The levels in 2003-04 were £190 million to £280 million (1.6 to 2.3 per cent). These levels are unacceptably high, and whilst the Department has made changes to its compliance procedures since 2004-05, there is currently no evidence to demonstrate a lower estimate for 2006-07. Consequently I have qualified my opinion on the Trust Statement.

2.56 It is important that the Department's work provides an accurate view of levels of error and fraud and it is looking to enhance the quality of this work by using specialist teams to undertake testing. It also needs earlier assessments of the overall level of error and fraud to improve its understanding of the effect of its compliance work.

2.57 In 2006-07 the Department carried out 137,930 checks on claims it assessed as higher risk. It has identified incorrect payments made of £151 million and prevented incorrect payments of £291 million (£250 million and £447 million in 2005-06). The reduction on 2005-06 is primarily due to fewer attacks by organised fraudsters, following the closure of the tax credit internet site in December 2005. The Department is developing a framework for validating the identity of individuals and will only re-open the tax credit internet system once this work is complete, which is unlikely to be before July 2008.

2.58 The Department's compliance examinations affect 2.5 per cent of awards, although all claims are subject to a series of checks before they are put into payment. The Department is now considering a broader range of compliance activity to increase its coverage of the tax credits population, aimed at increasing compliance and reducing levels of claimant error and fraud. The Department will always need to perform checks on claims assessed as high risk before payment to safeguard against error and fraud. The Department is now considering whether, in addition to these detailed compliance examinations, more frequent engagement with other groups of tax credit claimants would assist in the deterrence and prevention of error and fraud across the wider claimant population.

2.59 The Department has taken steps to improve the quality of service provided to claimants. It has a regular programme of enhancements to the tax credits computer system. The initial focus of these was to allow the Department to process new awards, make payments and renew awards. Subsequent software releases focused more on improving the service provided to claimants, for example by improving the information given. Software errors continue to result in some incorrect payments, and the Department has an ongoing programme of work to investigate these. The Department will continue to review the computer system to assess the impact of unresolved errors and it expects to address these through its improvement processes. On 26 May 2005, the Paymaster General announced steps to improve the Tax Credits system. The Department has undertaken a wide programme of work to deliver these commitments.

PART THREE

The collection of Income Tax through Pay As You Earn

Introduction

3.1 Pay As You Earn (PAYE) collects income tax at source from employment and pensions. In 2006-07 the Department collected £125 billion in income tax and £85 billion in National Insurance Contributions through two million PAYE schemes operated by employers and pension providers, in respect of over 50 millions jobs and pensions.[13]

3.2 PAYE is designed to collect the right amount of tax from people during the year, without the need for adjustments after the end of the tax year. During the year the employer calculates the tax due on earnings to date for the year. The Department issues a tax code, where appropriate, for each employee which indicates the amount of tax-free pay allowed. The Department bases tax codes on individual circumstances and revises these where it is notified of changes. The amounts deducted by employers are paid over to the Department each month or quarter. When an employee changes jobs the information about earnings, tax deducted and tax code should be transferred from the old to the new employer. At the end of the tax year, the employer provides a return of the amounts deducted from individual employees' earnings. The Department matches this information to its records and checks whether the right amount of tax has been collected.

3.3 In my Standard Report last year I noted the main challenges for PAYE included:

- The increasing complexity of the employment market. PAYE originated at a time when it was much more common for employees to have a single stable, full-time employment. But there has been a rise in the numbers of people in groups for whom PAYE is more difficult to operate, such as working students, short-term contract agency workers and pensioners. With employees changing jobs more frequently, or holding more than one job at a time, it becomes more difficult to ensure that the right amount of tax is collected during the year and to ensure that all the necessary information is brought together at the end of the year to check the accuracy of deductions.
- In this complex environment, the Department's computer systems are less well suited to the Department's task of effectively administering PAYE. The main PAYE system, COP (Computerisation of PAYE), was introduced in the 1980s and structures records around jobs, rather than individual taxpayers. The Department can therefore have difficulty in ensuring that taxpayers with more than one source of employment income during the year pay the correct amount of tax.
- At the end of the tax year, employers report to the Department the amounts deducted during the year for each employee and the information is checked against the Department's records. The majority of PAYE cases are cleared automatically, but about 30 per cent of cases cannot, for example, where the information received fails to match to a record or the amount deducted appears incorrect. These 'open cases' need clerical intervention and numbers of open cases have been rising in recent years, partly because the Department uses temporary reference numbers where an employee does not have a National Insurance number or has failed to provide it to his employer.
- In recent years there has been an increasing tendency for employees and employers not to provide the Department with accurate and timely information on income and changes in employment. When an employee changes jobs, they receive a form P45 from their old employer showing details of pay and tax to date and the current PAYE code. The new employer uses these details to make the right tax deductions from pay. However, in 70 per cent of job changes, the new employee does not present a P45 and the employee instead completes a form P46 showing basic information,

such as whether they hold more than one job. The employer therefore applies one of a limited range of codes until the Department has checked the P46 against previous records and issued an updated code.

- The difficulties in operating PAYE have been compounded by inconsistent working practices within the Department. Staff have not always worked cases accurately or followed Departmental guidance, particularly in cases with multiple sources of income and those with benefits in kind.

3.4 Based on sampling exercises, including the quality of its work in dealing with taxpayers with multiple sources of income and those receiving benefits in kind, the Department's Internal Audit has estimated that each year the Department may not be pursuing some £880 million of tax due, and taxpayers are likely to have overpaid around £340 million, resulting in potentially five million taxpayers not paying the right amount of tax. These reviews were undertaken in the period between 2004 and 2006 and provide estimates of the potential impact of weaknesses in the current PAYE schemes. They are not aligned to the Department's current clerical procedures.[14]

3.5 In response to these challenges, the Department has:

- introduced more rigorous, standardised working practices including more frequent quality checks;
- prioritised the working of benefits in kind information;
- introduced new computer support tools to improve the accuracy of work on calculating tax codes; and
- put in hand a major change programme to improve computer support for PAYE. In 2008, the Department plans to move PAYE processing onto the National Insurance computer system. It will then be able to structure information around a more complete view of each employee. In the mean time, staff working on PAYE have been given 'view access' to the information held on the National Insurance computer system to enable them to take account of all the information available when working cases. The process of updating records with benefits in kind information has also been automated.

3.6 As part of my work in 2006-07 I have examined the progress the Department has made in dealing with these issues and my report:

- provides an update on the issues identified last year and the actions the Department is taking;
- describes the Department's new governance arrangements for PAYE;
- considers the Department's handling of end of year information provided by employers and the continuing moves to filing online;
- examines the Department's approach to monitoring the quality of PAYE work and the current position on managing open cases;
- comments on the Department's compliance activity in relation to employers' obligations; and
- comments on a newly identified issue relating to the incorrect taxation of small occupational pensions and the action the Department has in hand to rectify the problems.

Action to improve and modernise PAYE

Enhancing PAYE governance

3.7 The administration of PAYE involves a number of business areas within the Department ranging from processing offices through to information technology and debt management. Towards the end of 2006 the Department established a new integrated governance structure to manage the end-to-end PAYE process to improve coordination and enhance collaboration across the different parts of the Department involved in its administration. The new structure includes a PAYE Management Board to ensure the Departments' directorates involved in operating PAYE work together, at a strategic level, to plan, manage and improve the performance of the process. The Management Board prepares an annual delivery plan, sets key performance indicators, and maintains a strategic risks and issues register and monitors and reports progress and addresses any major performance issues arising within PAYE. In addition, the Department has brought together the management of PAYE, Self Assessment and National Insurance into a single directorate.

End of year filing

3.8 Employers pay over to the Department all income tax and National Insurance deducted from employee earnings periodically (normally monthly) throughout the year. The Department receives a lump sum payment for these deductions, without information about the employees to whom they relate, so cannot allocate payments to individual employees. The Department does not demand detailed in year information from employers. PAYE was designed in this way so as to avoid placing an excessive burden on business. The Department can relate tax payments received in the year to employees only when it has received and processed employers' annual PAYE returns. These returns show total earnings, tax deducted and National Insurance Contributions and statutory payments under each PAYE scheme (form P35) and information on individual employees (form P14). Following the end of the tax year, submissions of P14s and P35s to the Department peak in April and May in the run up to the filing deadline of 19 May.

3.9 The Department reconciles amounts actually received from employers to this information and records income received and tax and national insurance paid by individual taxpayers. Where there is a difference between the tax due and the tax paid or the system fails to match other information on the taxpayer's record, the case is left open to be checked manually.[15] As shown in **Figure 1**, it can take over a year before the Department knows how much tax an individual has paid, and even longer to establish whether that amount is correct.

3.10 Employers also inform the Department of expenses and benefits in kind, such as a company car or private health care, provided to employees in the year. The process for handling this information is partly automated and partly manual. The computer checks the tax paid against what should have been paid. Where there are differences, clerical action is required to make repayments or collect underpayments and to change the tax code for the future so that the taxpayer pays the correct amount.[16]

1 Payment and Accounting for PAYE deductions

This diagram shows the time lag between an employee paying tax and the Department establishing from whom the tax has been received. The Department aims to process returns as quickly as possible, but its ability to process returns depends on the quality of information received.

Illustration

6 April: start of new tax year

April 2005 – March 2006: Employer uses the tax code as provided by HMRC to deduct income tax from an employee's salary and pays it over to HMRC, along with National Insurance contributions, by the 19th of the following month. No information about from whom the tax is deducted is provided.

By *19th May 2006*: Employer sends HMRC a return (P14 form) showing total income tax and National Insurance paid for the employee for the year.

After May 2006: HMRC processes the return and compares it to expected payment as per taxpayer's record on the PAYE system. Discrepancies will be investigated by local office staff. A small number of cases can take up to a year to resolve.

Source: National Audit Office

Improving the process for filing year-end employers' returns

3.11 In April 2002, the Chancellor of the Exchequer announced that the Government would implement the recommendations of Lord Carter of Coles' Review of Payroll Services to mandate online filing of employers' end of year returns. Employers with 250 or more employees have been required to file end of year returns online from the 2004-05 tax year and employers with 50 or more employees to file online from the 2005-06 tax year. Under Government proposals, employers with fewer than 50 employees do not have to file online until 2009-2010. But in accordance with Lord Carter's recommendations, the Department implemented a scheme of tax free incentive payments to encourage small employers to file online before this time.[17] In 2005-06 over 70 per cent (1.2 million) of the end of year returns received by the Department were sent online. And over 60 per cent (1.1 million) of employers with fewer than 50 employees sent their returns online.

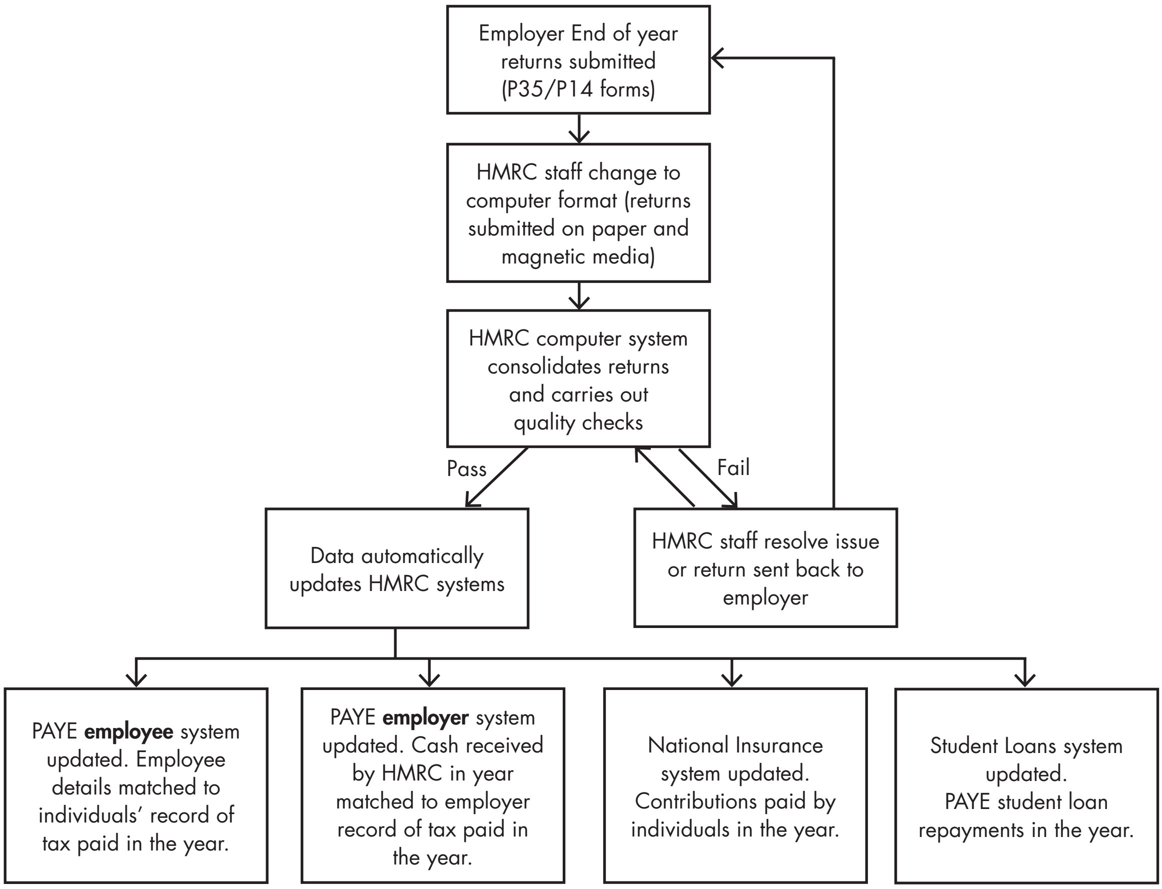
3.12 An overview of the process for submitting end of year returns and how these update the Department's computer systems is shown in **Figure 2**. A key feature of the system is the quality checking applied to employer submissions to ensure P35 and P14 forms are complete and accurate before updating the Department's main PAYE and National Insurance systems. The Department normally refers any forms that fail these checks back to the employer.

The introduction of online filing by employers

3.13 As I have previously reported, the Department encountered difficulties in 2005 with the initial implementation of the computer system to support the online processing of employers end of year returns. Delays in implementing computer changes meant that the system for quality checking and automatically processing returns was not ready until June 2005. The Department had to introduce contingency arrangements to store returns until it could begin processing in June. Because of the delays in the delivery of the full system, the Department decided that it would only contact an employer or send a return back for correction if it could not correct the errors itself. It set up an in-house team to correct those returns that failed the validations because of employer error.

3.14 As this was the first year of online filing, some employers were unfamiliar with the acceptance messages issued under the contingency system for returns received, and sent duplicate returns. The Department also experienced problems where some software used by employers was incompatible with its own system.

2 The end of year process



Source: National Audit Office

3.15 As a consequence of the additional work to clear the processing backlogs the Department's target to process by 31 March 2006 98 per cent of 2004-05 employee details submitted was met one month late. These backlogs also affected wider aspects of the Department's work:

- the PAYE system was delayed in carrying out its check to ensure employees had paid the right amount of tax in the year, increasing the number of open cases (this is discussed in more detail in paragraphs 3.35 – 3.41);
- some records on the National Insurance system were delayed in being updated which meant the Department issued deficiency notices to a number of individuals where their employers scheme had not been processed; and
- the delay in providing up to date information to the Student Loan Company meant that an estimated 50,000 student loan statements for 2004-05 were issued by the Company in September 2006 that incorrectly showed that no repayments had been made.

Improvements for processing 2005-06 returns

3.16 The Department made a number of improvements for the processing of 2005-06 employer returns, involving:

- a programme to educate those employers who had made errors when submitting their 2004-05 returns and the operation of validation rules throughout the process to reject automatically returns which did not meet the Department's quality standards. This helped reduce to five per cent the proportion of returns sent back to employers for correction. The Department estimates that 13 per cent of 2004-05 returns failed to meets its quality standards;

- the production of a revised processing plan, detailing key milestones and targets in the processing of employer year-end returns. The Department operates an End of Year forum, involving representatives from its PAYE, Self Assessment and National Insurance Directorate and other relevant parts of the business, to monitor and oversee performance against the plan; and
- completing its implementation of all the functions provided by the computer system.

3.17 The processing of 2005-06 end of year returns ran more smoothly than 2004-05, as shown by **Figure 3**. By the end of October 2006, just over four months after the deadline for submissions, the Department had successfully processed 86 per cent of the 2005-06 P14 forms, compared with 57 per cent in the equivalent period for 2004-05 returns. At March 2007 there were 1.17 million PAYE taxpayer records which required updating for information on 2005-06 returns – this level is much lower than the position at same time in the previous year (19.2 million).

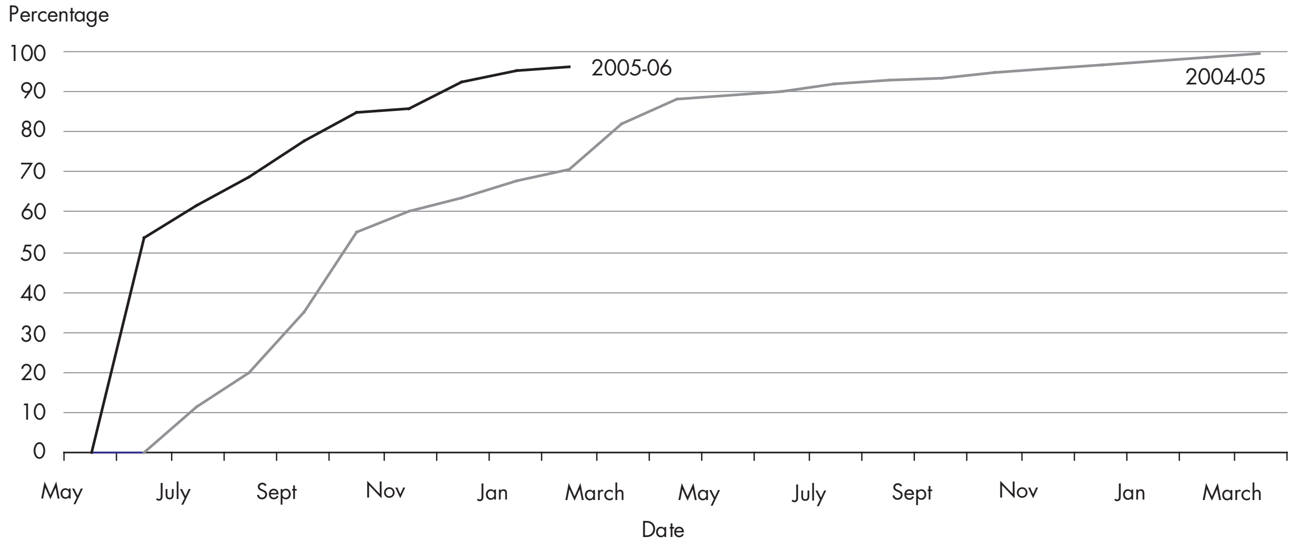
Progress in processing 2006-07 returns

3.18 The Department's feedback through its contact with employers and software developers is that 2006-07 has been a much more successful online filing year in comparison with the previous two years. More online returns have been received and the proportion of rejected claims has continued to fall. By 28 May 2007, the Department had received 1.8 million returns for 2006-07 of which 1.4 million were received online. The figure of online returns received at the same time last year for 2005-06 was 1.2 million. 1.4 per cent of returns were rejected with errors for 2006-07 compared with five per cent for 2005-06.

3.19 The Department experienced some problems with the online filing system in 2007, including some agents not being able to access their client's information on the system for nine days in early May. While the Department resolved these issues reasonably quickly, the impending filing deadline meant this inevitably caused difficulties. Some representative bodies sought an extension to the filing deadline because of these problems. The Department felt this was not necessary because the problem was resolved quickly and because it would not charge employers a penalty if they submitted their return by 28 May under an existing published concession that takes effect every year. The Department believes that no employers were forced to file after 28 May because of these problems.

3 Processing year end returns to the National Insurance system: comparison of 2004-05 and 2005-06

This figure shows the time taken to fully process employers' end of year returns for 2004-05 and 2005-06. The filing deadline is the 19 May following the end of the tax year.



Source: HM Revenue & Customs

3.20 Although the Department believes that the filing experience for the vast majority of customers was good, it accepts that there are a number of lessons to be learnt around planning, communications and response times and is taking this forward as part of reviewing 2006-07.

3.21 The Department believes that the computer systems introduced in 2005 are now working as designed and are beginning to deliver the improvements in processing that these were intended to bring. The Department began to process information on individuals on 9 April and up to the end of May has processed 70 per cent of returns to the National Insurance computer system. That compares to 20 per cent for 2003-04. The Department has a target to process 98 per cent of P14s received by 31 December 2007, but it currently anticipates it will reach this target by 30 September 2007. This means that individual tax and National Insurance records will be up to date and that individual information is sent to other Departments, such as the Department for Work and Pensions and the Student Loan Company much sooner than in previous years.

Extension of online filing

3.22 A further review of the Department's online services by Lord Carter, published in March 2006, recommended that businesses should be required to file in year returns (forms P45 and P46) electronically, starting with large and medium sized employers from April 2008. Following the consultation process, mandatory online filing was deferred until April 2009 to provide employers with additional time to prepare for the change. Although employers who wish to file online before this time can do so.

3.23 The Department is taking action to ensure the lessons from the introduction of the system for year end returns are taken into account in developing systems for in year filing. The team responsible for implementing Lord Carter's second review has worked closely with – and includes some members of - the team involved in delivering online filing for year end returns. Furthermore, at an early stage in implementing Lord Carter's new recommendations, the Department held discussions around the lessons learned to ensure its plans were informed by earlier experience. Specific examples of lessons learned include:

- making test services available to software vendors six months before any major changes to online services. This follows concerns by vendors that they did not have sufficient time to develop their products for end of year filing; and
- the importance of developing and building a collaborative relationship with software developers, employers and their agents. By building on the relationships already established, the Department considers it has been better able to understand customer needs and work with its stakeholders to develop ideas for improving the in year process.

Measures to improve the quality of processing

3.24 The Department needs to process taxpayers' information at various stages in the operation of PAYE, for example to adjust a tax code to reflect benefits-in-kind or where an employee changes job. In my 2006 report, I noted that staff had not always been aware of or followed Departmental policies which had resulted in inconsistent practices being followed or inaccurate processing. The Department has introduced a number of measures to improve the quality of its processing.

3.25 In 2004 the Department introduced a spreadsheet based tool, Coding Assistant, to reduce the need for manual calculation of tax codes, which has improved accuracy in coding decisions. While the Department made use of Coding Assistant mandatory in July 2005, there were delays in achieving widespread implementation and it only began to have a major impact in early 2006-07. The Department also operates a quality improvement process within individual processing offices to help managers identify the cause of errors, take action to prevent them recurring and to help staff learn and improve.

3.26 The Department also undertakes a Quality Monitoring Exercise (QME), an independent monthly check on a sample of work across all processing offices, to ensure they meet national standards[19]. The results provide managers with timely information on performance, highlighting areas of weakness, and on the effectiveness of the quality improvement arrangements within offices. From November 2005 the Department has performed its monitoring of PAYE processing through QME on a monthly basis, rather than the previous annual basis.

3.27 The majority of PAYE cases are processed automatically, but around 30 per cent require manual processing which is more prone to error. The Department's QME data show that the accuracy rate for all cases (manually and automatically processed) gradually improved from 2002-03, but fell during 2005-06 to 94.7 per cent against a target of 97.5 per cent. 2006-07 results displayed a slight improvement, but still fell short of the target.

3.28 For manually processed cases only, the accuracy rate has declined since 2002-03 to 79.9 per cent in 2005-06, well below the target of 89 per cent. The performance improved during 2006-07 to 82.1 per cent but was still well short of the 91 per cent target. At present almost one in five manually processed cases therefore contains errors with a financial impact on taxpayers. The Department aims to increase the accuracy rate to 93 per cent for 2007-08.

3.29 The fall in accuracy rates stems in part from changes in the caseload. Since 2004-05 certain taxpayers with simpler financial affairs are no longer required to file a Self Assessment tax return. This brings wider benefits but it has increased the volume of more complex PAYE processing as their cases are now processed entirely through this system. 1.15 million cases were transferred in 2004-05 and a further 0.3 million cases in 2005-06.

3.30 The Department has embarked on an initiative within local offices known as "Lean", as part of its Processing Pacesetter Programme. This aims to increase efficiency by eliminating duplication or reworking, improving accuracy, increasing productivity and reducing processing times. One significant aspect of this initiative is the introduction of quality checks by managers to identify errors before they impact on the taxpayer. In 2006 and 2007, following a successful pilot involving three large processing offices, the Department has been rolling out "Lean" to other offices. My report on HMRC: Accuracy in Processing Income Tax [HC 605, session 2006-07] examines in greater detail the Department's levels of accuracy in processing Income Tax, the causes of errors and their impact, and changes underway in the Department to improve the accuracy of processing.

Measures to address processing delays and incomplete information

3.31 In addition to the Department's work to improve the accuracy of its processing work on PAYE information, the Department is taking steps to improve the timeliness of its processing and to provide staff with a better view of individual taxpayers' affairs, taking account of all the information it holds.

Processing benefits in kind information

3.32 The process for handling benefits in kind information is partly automated and partly manual. The computer checks the tax paid against what should have been paid, before clerical action makes repayments or collects underpayments. My 2005-06 report showed that the necessary clerical action was not always being undertaken and computer printouts were not being worked accurately and/or in a timely manner because of competing work priorities. The failure to process benefits in kind information has contributed significantly to the overall errors in PAYE. Through a sampling exercise, the Department estimates that these failures potentially account for £181 million tax being overpaid and £519 million tax being underpaid, affecting 1.9 million taxpayers.

3.33 The Department has examined how it can improve its performance in response to these findings. It has reminded staff of the need to process this work on a timely basis and has targeted resources at higher risk cases. The NAO visited a number of processing offices and found that the Department had dedicated specific resources to this task. But due to deficiencies in management information systems the Department cannot monitor whether its instructions have increased the number of benefits in kind work items being processed.

3.34 In May 2007 the Department introduced an automated process for managing changes to tax codes for benefits in kind. This should reduce the risk of processing error and of necessary changes not being processed by staff and help ensure that the correct amount of tax is paid sooner. But the actual effect of these changes will not be known until 2008 after it has completed its processing of benefits in kind received in 2007-08.

Managing 'Open Cases'

3.35 'Open cases' are a normal part of the PAYE process but changing employment demographics have increased the numbers generated in recent years. In 2006-07 one million people started work for the first time, there were 13 million job movements and 20 per cent of all jobs lasted less than one year. There were also nearly four million employees with more than one source of income.

3.36 At the year end, the Department's computer system checks whether the tax an employee should have paid in the year is consistent with year-end pay and tax information received from employers. The computer identifies discrepancies or fails to match information to a taxpayer's record in approximately 30 per cent of cases and these open cases must be checked manually. The Department may have to wait some time before it has sufficient information to complete these checks, for example, when it does not have complete employment details. Reasons for open cases arising include:

- the Department holding incorrect information on employees because employers provided inaccurate details such as the wrong National Insurance number;
- the employer operated a different code from that on the taxpayer's record; and

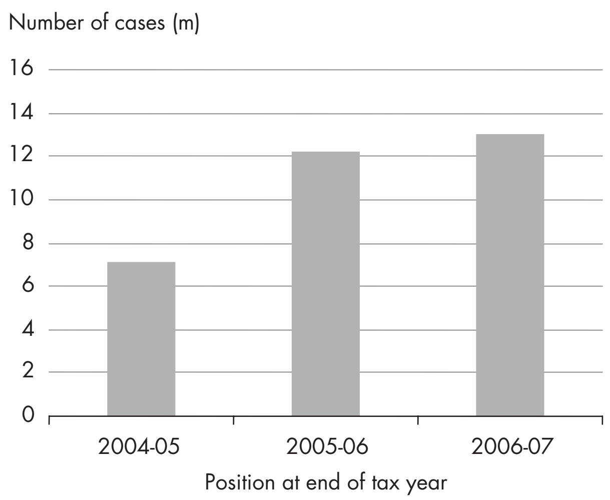
- the Department holding incomplete information due to employers and employees not providing the Department with timely and accurate information on changes in employment. This can make it difficult for the Department to obtain a full picture of an individual's employments, particularly where employees leave jobs near the end of year.

3.37 Delays in clearing these records can mean that taxpayers are not notified on a timely basis of additional tax payable or refunds due. The Department's initial business plans for 2006-07 predicted that there would be six million open cases at 31 March 2007. It increased this projection to 10.6 million for a variety of reasons including low take up of overtime. But there were actually 13 million open cases at March 2007 as shown in **Figure 4**.[19] These high levels partly arose because of delays in the system for processing employers' year end returns discussed in paragraph 3.13. In addition the Department was unable to allocate all of its planned staff resources to open case work.

3.38 The Department has taken measures to reduce the number of open cases including:

- redeploying some staff to work on open cases and using staff in other areas to help with the easier cases. It has also offered more overtime for its more experienced staff to help it deal with the more difficult cases; and
- introducing an automated process to bring together information on all the employments of a taxpayer prior to the year-end checks. The Department estimates that this will reduce the level of open cases by 10 per cent.

4 Number of Open Cases



Source: HM Revenue & Customs

It expects these measures – along with a greater management focus on clearance of open cases – to reduce the number of open cases to 10.5 million by March 2008.

3.39 The Department's staff need to examine manually each open case to resolve the discrepancy. In 2006, its Internal Audit Office carried out a sampling exercise and found that errors in processing open cases resulted in the wrong tax being paid in 16 per cent of cases. While these errors are high, they have reduced from 26 per cent in 2000-01. The Department estimates some 80 per cent of the errors occur because:

- it failed to bring together all the information it needed to examine the case properly;
- it had not updated the taxpayer's record with information held for their temporary reference number – the Department creates a temporary reference number for each employment where an individual's National Insurance number is not known. Some taxpayers incorrectly have more than one temporary reference number or a temporary reference number in addition to a National Insurance number; and
- it had not adequately maintained taxpayer records, despite its efforts to improve data quality.

3.40 In September 2006 the Department gave around 17,000 staff access to taxpayer information held on the National Insurance system. This aimed to provide PAYE staff with full details of a person's employment history and make it easier to check if the right amount of tax had been paid. It should also assist staff in processing open cases. My staff found this to have been well received by teams in the sample of offices visited.

3.41 The Department believes however that the changes to create a single view of an employees' tax affairs discussed below will help them manage open cases more effectively by reducing the number arising in the first place and giving staff better quality information to process them accurately.

Creating a single view of employees' tax affairs

3.42 The PAYE computer system structures records around jobs rather than individual taxpayers. Currently employment records are held in 12 regional databases. As a result, the Department can have difficulty in ensuring that taxpayers with more than one job or pension pay the correct amount of tax until records are consolidated after the end of the tax year. Based on its most recent analysis of sample data on taxpayers with multiple sources of income, the Department estimates that each year potentially £140 million tax was overpaid and £280 million tax underpaid, affecting some 1.2 million taxpayers.

3.43 The Department recognises that fundamental changes are necessary to address these problems. In April 2007 it introduced automatic consolidation of end of year employee details. This is intended to ensure that more employees with multiple sources of income or who have changed employments during the tax year will pay the correct amount of tax sooner, because manual intervention to check whether tax has been overpaid or underpaid will be needed in fewer cases. In May 2007, the Department also introduced automatic coding of employee benefits in kind to further ensure that employees will be paying the right amount of tax sooner.

3.44 In 2008 the Department plans to move from its Computerisation of PAYE (COP) database to its National Insurance computer system as the basis for administering the PAYE process. This will bring together an individual's PAYE details by reference to their national insurance number irrespective of the number of sources of income, provide a complete view of an employee's income and enable that single view to be maintained more effectively, further enhancing the Department's ability to ensure that the correct tax is paid when there are multiple sources of employment income. The staff view will also have a contact history facility that will record contact with the customer or their employer whether received electronically, by phone or post. In some cases the system will provide an automatic update to the contact history; in other cases staff will update the record themselves. This should mean that the Department provides an improved customer service as staff dealing with taxpayers cases will have a more complete picture of the taxpayers details and be better able to resolve the enquiry in one go.

3.45 On top of all these improvements, in April 2008 the Department plans to introduce new automatic checks on employee starter and leaver information submitted either online or on paper so that the quality of information that goes onto the National Insurance computer system will improve, and result in fewer enquiries to employers and employees.

3.46 Successful implementation should reduce significantly the major source of errors. The Department plans to make the computer changes in 2008-09, the earliest date it considers possible given the scale of migration to a different system and its technical challenges. The Department is taking action to ensure successful implementation by planning the movement of data from the old systems to the new, and planning how to resolve cases that will not transfer. The Department also plans to test the computer system thoroughly before it is introduced.

Taxation of small personal and occupational pensions

3.47 Consultations between the Department and pension providers around the newly implemented arrangements to tax retirement annuity contracts under PAYE have highlighted errors in the taxation of some small personal and occupational pensions which mean that many pensioners have not been paying tax on otherwise taxable pension income and others have been under-taxed. The Department estimates, through a sampling exercise, that of an estimated 8.9 million pensions in payment it has not collected income tax from around 420,000 of these with a potential tax loss of some £135 million per annum as a consequence.[20]

3.48 The Department believes this problem dates back to 1983 when its PAYE computer system was introduced. At this time it published guidance to pension providers which was not strictly in line with the PAYE regulations and processes. This guidance advised pension providers not to operate PAYE for new pensions when no form P45 was produced by the pensioner and the pension payment was below the basic personal tax allowance. This meant that no form P14s were to be submitted to the Department. Instead, the pension provider was advised to merely retain for three years a list of payments made. The precise rationale for these instructions are now unclear but the Department believes they were introduced as a short term measure to reduce the volume of data needing to be processed at the time PAYE was computerised; but the practice has only recently been withdrawn.

3.49 In addition to this incorrect guidance a number of inappropriate local agreements were made between local tax offices and pension providers to exclude some pensions from tax on a 'de minimis' basis. These agreements varied but, typically were for tax not to be deducted from pensions of £500 or less; this included agreements where NT (i.e. "no tax") codes were operated and P14s were submitted as well as cases where PAYE was not operated at all. In some cases it now appears that the 'de minimis' amounts have been increased over the years, in some cases with the authority of the local tax office and in some cases without. This means that some larger pensions might now be going untaxed.

3.50 In cases where pension providers submit form P14s for individual pensions, the Department should consider if the individual has a tax liability when the pension is aggregated with the pensioner's other income. But as noted in paragraph 3.3, the nature of the PAYE computer system sometimes makes it difficult for the Department to bring together different sources of income for an individual. Many of these P14s were deposited in a "residual file" to support any subsequent examination of the individuals' tax affairs. But the Department did not routinely take action to examine these forms.

3.51 The Department first became aware of this issue in April 2005 and it changed its incorrect guidance. But it did not explicitly notify pension providers of the changes and they generally went unnoticed and were not implemented. Furthermore, the Department believes that some of its local offices agreed with pension providers to continue their previous local agreements when they queried the changed instructions. The Department is now engaged on a programme of work to withdraw systematically the incorrect local agreements.

3.52 The Department is now taking the following steps to correct the tax treatment of these pensions which involve:

- determining the number of pensions and pensioners not being fully taxed;
- consulting with the pension providers to fully assess the scale of the problem and establish complete records of all pensions classified as small or de minimis and not being properly taxed;
- developing an action plan to correct the tax treatment at the earliest opportunity. The Department's decisions on the timescale are influenced by its desire to manage the impact on pensioners who have previously not been taxed or have been under-taxed on their pensions. Furthermore, it needs to provide pension providers with sufficient time to make the necessary changes to their systems. The Department also needs to ensure that its own systems are ready to handle the changes; and
- ensuring that no action is taken to recover tax for years before 2006-07 where, as in the majority of cases, there has been no failure on the part of individual pensioners.

3.53 At the time of my report the Department had not finally yet set its timetable for corrective action but it envisages obtaining P14s from pension providers for all pensions in payment for 2007-08 by May 2008. The changes in the PAYE computer system described in paragraph 3.44 will then consolidate pension records with any other details held in relation to individual pensioners. This would result, for most cases, in correct 2008-09 tax codes (including NT codes where no tax is properly due) being issued to pension providers. It would also allow any 2007-08 tax underpayments to be established and collected in 2008-09 or later years. P14's which could not be matched with a taxpayer record would be dealt with as open cases requiring manual intervention (described in paragraphs 3.35–3.41). The Department is developing in parallel a communication strategy to cover this corrective action.

The Department's compliance activity over employers

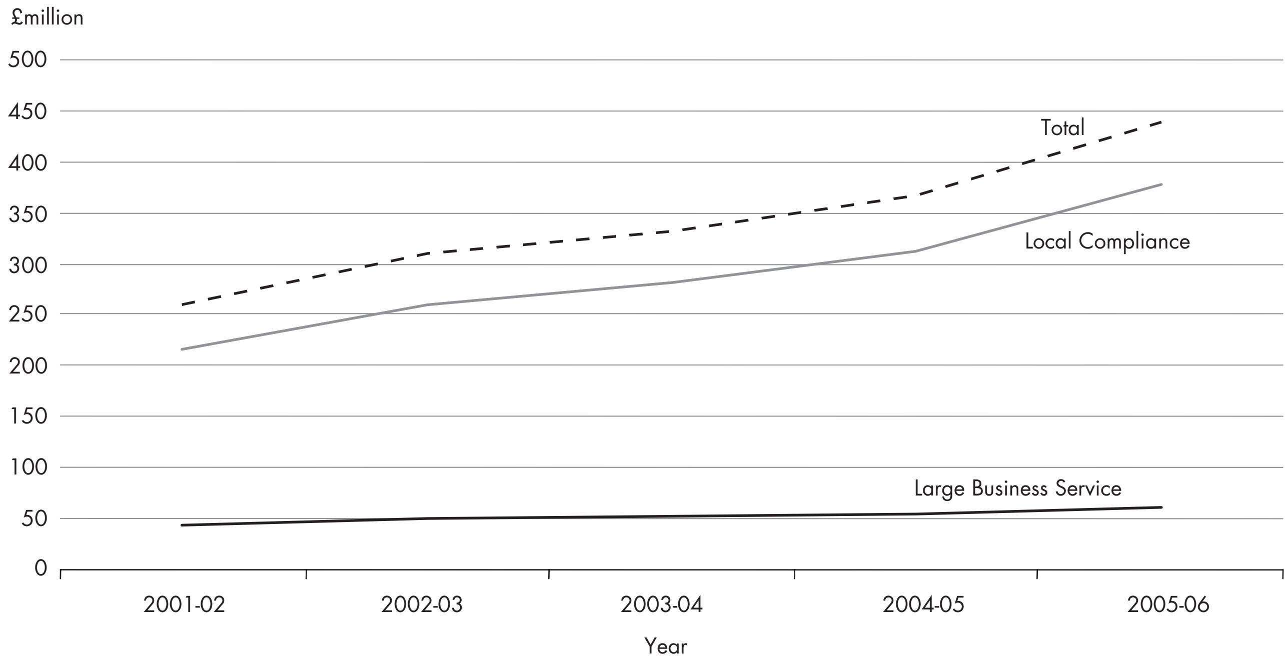
3.54 The Department carries out compliance work to provide assurance that employers are meeting their statutory obligations in operating and collecting PAYE and National Insurance Contributions. The Department's compliance teams visit selected employers to assess their PAYE processes and, where necessary, sample test underlying records.

3.55 The Department's Large Business Service (LBS) is responsible for enforcing compliance within the UK's largest employers. It carries out around 250 reviews each year. The Department's Local Compliance function is responsible for the inspection of "smaller" employers, and carries out roughly 18,000 reviews each year. Compliance reviews generate additional tax yield where employers made errors in operating PAYE. Another important aspect of PAYE compliance work is the enabling activities performed by review teams, which are designed to help improve employers' systems and avoid future errors.

3.56 The Department's statistics show that tax yields from PAYE compliance reviews are increasing year on year, particularly in relation to Local Compliance reviews. As shown in **Figure 5 overleaf**, in 2005-06 the Department generated additional tax of £439 million (£366 million in 2004-05). The Department does not set yield targets for compliance work.

3.57 The Department's methods of selecting employers for review are regularly evaluated to ensure that employers most at risk of non-compliance are targeted wherever possible. During 2006-07 LBS reviewed its risk assessment processes to make better use of intelligence gathered by Local Compliance teams in identifying employers for review.

5 PAYE Compliance Yield



Source: HM Revenue & Customs

Conclusions

3.58 In 2006-07 the Department collected £125 billion in income tax and £85 billion in National Insurance Contributions through Pay-As-You-Earn (PAYE), the Government's largest source of tax revenue. The Department aims to ensure that individuals pay the right amount of tax on their income and to make it as easy as possible for employers and employees to meet their obligations.

3.59 As I noted in my 2005-06 report, the Department's PAYE computer systems are not well suited to the efficient administration of income tax where people have more than one job or change jobs on a regular basis. This is because the systems structure tax records around jobs rather than individual taxpayers. As a result, the Department can have difficulty identifying all relevant sources of income when calculating tax that should be paid. These difficulties have been compounded by inconsistent working practices within the Department as a consequence of staff not being aware of or failing to follow Departmental procedures, for example when adjusting tax codes for Benefits in Kind. Based on its most recent estimates, each year the Department may not be pursuing some £880 million of tax due, and taxpayers are likely to have overpaid around £340 million, resulting in potentially five million taxpayers not paying the right amount of tax.

3.60 During 2006-07 the Department introduced a number of measures to improve the quality of PAYE processing. It has mandated use of a spreadsheet tool to improve accuracy in coding. It has also operated a quality improvement process to help managers identify the cause of errors, take action to prevent them recurring and to help staff learn and improve. This consists of independent monthly checks across all processing offices to provide better information on overall performance against national standards. The Department has embarked on an initiative within local offices known as "Lean", as part of its Processing Pacesetter Programme. This aims to increase efficiency by eliminating duplication or reworking, improving accuracy, increasing productivity and reducing processing times. The Department's data shows that in 2006-07 the accuracy of processing improved in comparison with the previous years, but still fell short of target.

3.61 The Department has also taken steps to improve the timeliness of processing and ensure it takes into account all the information it holds on a taxpayer. It has dedicated resources to dealing with benefits in kind cases, but weaknesses in management information prevent it from assessing the effect on processing. For 2007-08 the Department has introduced a process to automate the coding of benefits in kind information which should further improve the timeliness and accuracy of processing by reducing manual intervention. It also introduced a process to reduce the number of open cases automatically generated. These measures should improve the timeliness of processing, but in the absence of management information it is difficult to assess their effect. During 2007-08 the Department should quantify the success of these measures in reducing levels of error.

3.62 The Department recognises that real improvement in the operation of PAYE can only be achieved through fundamental changes in its computer systems. It therefore plans to move to its National Insurance computer system as the basis for administering the PAYE process. From 2008-09 this will allow all information on individuals to be brought together under their national insurance record and provide the Department with a complete view of a taxpayer's employment income.

3.63 The Department did not fully implement on time its new computer system to support the online filing of employers' 2004-05 year end returns. The system to validate and process online returns was not ready until June 2005, a number of weeks after the 19 May filing deadline. The Department implemented contingency arrangements to allow it to receive returns, but as a result the Department could not notify employers if their submissions were successful, identify returns that failed to meet quality standards, or accurately identify employers who missed the filing deadline. Because of these delays the Department accepted responsibility for resolving problems with returns, rather than referring them back to employers. But this caused significant pressures within the Department to deal with the resulting backlogs and meant some of the information needed to support the processing of individual records on the PAYE, National Insurance and student loans system was not available.

3.64 The Department made improvements for processing 2005-06 employer returns, involving identifying returns which did not meet quality standards; providing employers with better guidance; completing its implementation of all the functions provided by the computer system; and developing a comprehensive plan for processing returns. By the end of October 2006, just over four months after the deadline for submissions, the Department had successfully processed 86 per cent of the 2005-06 P14s, compared with 57 per cent in the equivalent period for 2004-05 returns. The number of returns that failed to meet its quality standards fell from 13 to 5 per cent. Early indications show that the 2006-07 online filing season has been more successful that the two previous years with 1.4 million returns received online, compared to 1.2 million for 2005-06, and 1.4 per cent of returns rejected with errors.

3.65 The Department has recovered from the problems encountered in 2004-05, but the measures needed in 2005-06 highlight the weaknesses of the original implementation. The Department needs to ensure it applies the lessons learned when extending the system to small employers and in-year filing. In particular it needs to ensure the system is fully developed and tested before it is introduced, external users are educated and supported in use of the system, and processing is supported by clear plans.

3.66 Since the early 1980's some pension providers have not deducted tax under PAYE from all pensions in payment. This is due to a combination of incorrect central guidance from the Department, inappropriate local agreements and failures by local offices to implement agreed procedures. The precise rationale for this is now unclear, although it is likely that these decisions were taken because staff did not consider the effect to be material against the administration savings for the Department and pension payers. But the Department now estimates this means it is potentially not receiving income tax from 420,000 pensions and its current estimate is that the tax loss is around £135 million per annum. The Department first became aware of this issue in April 2005 and corrected its guidance. But it did not explicitly notify pension providers of the changes and they generally went unnoticed. The Department has now begun a systematic programme of work to put these pensions on a proper footing but it does not intend to recover tax which has not been deducted in previous years. The Department also needs to consider where else it has made judgements not to collect tax on the grounds of size and how it can obtain better assurance that its local offices are following central guidance. It also needs to ensure that when it changes guidance, this is accompanied by a wider programme of work to bring this to the attention of those affected and undertake compliance work to ensure these changes are implemented.

PART FOUR

The collection of Income Tax, National Insurance and Capital Gains Tax through Self Assessment

Introduction

4.1 Taxpayers with a number of sources of income and with less straightforward financial affairs are required to complete Self Assessment returns to establish how much Income Tax they should pay. These include the self employed, business partners, company directors, landlords, those with foreign income and any others with 'complex tax affairs'. In 2006-07 the Department issued Self Assessment returns to 8.7 million self employed and higher rate PAYE taxpayers, 570,000 partnerships and 225,000 trusts and the Department collected £26.6 billion (after repayments) income tax, class 4 National Insurance Contributions and Capital Gains Tax through the system.[21]

4.2 The Department's objective is to provide a good service to customers and to the Exchequer by making the obligation to self assess as easy as possible for taxpayers to understand and comply with. It operates an online Self Assessment service and taxpayers are encouraged to file their tax returns electronically. The Department has two main Public Service Agreement targets for Self Assessment relating to the timely receipt of returns and online filing. In 2006-07, the Department did not meet its target for the percentage of self assessment returns filed on time, but exceeded its target for the percentage of returns filed online as shown in **Figure 1.**

4.3 This part of my report considers how the Department administers Self Assessment. It examines how it manages the receipt and processing of returns, the enquiries it undertakes, how it ensures taxpayers comply with their obligations and its procedures for handling repayments and collection of debt.

The Self Assessment process

4.4 The introduction of Self Assessment represented a major change in the administration of tax for those who receive tax returns. Under this system, the primary responsibility for calculating the tax liability shifted from the Department to taxpayers. Taxpayers are required to complete returns to establish how much income tax they should pay and to provide the Department with the information it needs to validate this calculation. The Department estimates that approximately half of Self Assessment taxpayers use an agent to complete their return (ranging from tax professionals to relatives). Taxpayers have a statutory obligation to submit their returns for the preceding tax year by 31 January. The Department operates a statutory penalty regime for taxpayers who fail to meet this deadline. The timetable for filing returns is set out in **Figure 2**.

1 HMRC's targets for the filing of Self Assessment returns

Target	2004-05		2005-06		2006-07	
	Target	Result	Target	Result	Target	Result
By 2007-08 increase the percentage of Self Assessment returns filed on time to at least 93 per cent	90.6	90.6	90.6	90.3	91.5	89.2
By 2007-08 increase the percentage of Self Assessment returns filed online to 35 per cent	Not set	16.8	25	24.3	29	35.1

Source: HM Revenue & Customs

2 Self assessment timeline

- 5 April – end of tax year.
  6 April – start of new tax year.
- April – tax returns and notice to file issued for tax year just ended - those previously filing by internet or substitute returns sent a notice to file.
- 31 July – second and final instalment of tax to be paid (first instalment due by 31 January).
- 30 September – deadline for submitting paper returns if taxpayers want HMRC to do the tax calculation or change the tax code to collect an underpayment of £2,000 or less.
- 30 December – deadline for filing by Internet for changing the tax code to collect an underpayment of £2,000 or less.
- 31 January – final deadline for submitting a return
  – payment date for tax date.
  – balancing payment for Payment on Account cases.
- 1 February – if tax return not submitted then late filing penalty of £100 due.
- 28 February – automatic five per cent surcharge on any tax owed.
- 31 July – A second £100 late filing penalty due if tax return from previous January still outstanding. Second automatic five per cent surcharge on any tax owed.

Penalties and interest charges start for overdue returns and tax due

Source: HM Revenue & Customs

4.5 The Department processes the information included in returns to record the taxpayer's self assessment and to calculate the tax payable or repayable, and provide PAYE taxpayers with an accurate tax code. This process is generally automated where returns are received online. But the Department has to manually enter information into its computer systems where it receives paper returns.

Recent improvements to the Self Assessment Process

4.6 The number of taxpayers having to file Self Assessment returns increased from 8.5 million in 1996-97 to 9.5 million in 2003-04. In 2004-05, the Department revised the criteria for including people within Self Assessment and removed over one million from the system, mainly employees and pensioners with very straightforward financial affairs. The Department's efforts to reduce the Self Assessment population have been largely offset by increasing numbers of self employed taxpayers and highly paid employees. In 2006-07 9.5 million individuals, partnerships and trusts were required to submit returns.

4.7 In 2005 the Department further simplified the Self Assessment process by introducing a short tax return and simpler guidance for people with simple tax affairs. The Department issued this four page return to around 1.5 million Self Assessment taxpayers for the 2006-07 tax year.

4.8 The Department has a project to introduce a re-designed main tax return from 2007-08 (which will be first issued in April 2008). It aims to reduce the burden on taxpayers by introducing a simplified return that is easier to complete and to provide guidance that is easier to understand. This will also reduce the number of pages that some taxpayers are required to complete.

Self Assessment governance

4.9 The administration of Self Assessment involves a number of business areas within the Department, ranging from teams processing returns and undertaking compliance enquiries to collecting debt and providing computer support. In 2006, the Department established a new integrated governance structure to manage the end-to-end Self Assessment process to improve co-ordination and enhance collaboration across the different parts of the Department involved in administering the process. The new structure includes a Self Assessment Management Board to ensure the Department's directorates involved in operating Self Assessment work together, at a strategic level, to plan, manage and improve the performance of the process. The Board prepares an annual delivery plan, sets

3 Self assessment requirements by taxpayer

Taxpayer category *Complexity of financial affairs*		**Type of return to be filed**	**Number of people 2006-2007**
Very simple	Employees and pensioners with very straightforward affairs who largely pay most of their Income Tax due through Pay As You Earn.	Not required	29 million
Simple	Some employees who receive other income, the self employed with turnover of less than £15,000, some pensioners, people with property income in the United Kingdom below £15,000 and people receiving saving and investment income.	Short Return* (four pages)	1.1 million
More complex	Some higher rate employees who may also receive other income, the self employed with turnover of greater than £15,000, pensioners, people with property income in the United Kingdom above £15,000 and people receiving saving and investment income from overseas.	Full Return* (10 pages, plus supplementary pages for certain taxpayers)	7.6 million

* But taxpayers may instead choose to file online returns.

This table does not include partnerships and trusts.

Source: HM Revenue & Customs

key performance indicators and maintains a strategic risks and issues register. It then monitors and reports progress against the plan and the indicators and addresses any major performance issues arising within self assessment. Whilst there is close liaison between the Department's compliance function and the Self Assessment Management Board, compliance is not part of the formal governance structure.

4.10 In addition, the Department has brought together the management of PAYE, Self Assessment and National Insurance into a single directorate.

Getting Self Assessment returns in

4.11 Taxpayers are legally required to submit a Self Assessment return when the Department issues a tax return (which includes a notice to file) or a notice to file. The Department issue a paper return only to those who are expected to submit a paper return. It issues notices to file to people who have previously filed online or used a computer generated substitute. Taxpayers are also legally required to notify the Department if they have untaxed income or capital gains and the Department has not issued a Self Assessment return.

Filing on time

4.12 Each year around 10 per cent of taxpayers fail to meet the 31 January statutory deadline for filing. The Department has introduced a number of measures to encourage taxpayers to file returns on time, it:

- performs the tax calculation for taxpayers who submit returns by the end of September;
- runs advertising campaigns reminding taxpayers of the key filing deadlines; and
- contacts by letter or telephone a number of taxpayers within groups who had either previously filed late or are new to self assessment

4.13 In 2006-07 around one million taxpayers did not submit returns by the 31 January deadline and the Department failed to achieve its target of 91.5 per cent of returns filed on time, as shown in **Figure 4**. The results were also lower than those for the previous two years. The Department is undertaking research to identify if there is any particular group or factors that explain the performance, but its preliminary analysis suggests that the shortfall was due to:

- reduced media advertising in 2006-07, compared with previous years; and
- a temporary, and now resolved, problem in the process that loads individuals' details into the Department's automated dialling system restricted the Department's telephone campaign to remind some individuals new to Self Assessment of their obligations to submit a return. The problem meant that instead of the intended target audience of 312,565, the Department was able to make contact with only 80,000 people. But the Department was able to select and attempt contact with a further 773,000 taxpayers in other groups (for example, those who had filed returns late in an earlier year).

4 Self Assessment returns processed for the preceding tax years

Processing Year	2003-04		2004-05		2005-06		2006-07	
	Millions	%	Millions	%	Millions	%	Millions	%
Issued by HMRC	9.47		9.84		9.08		9.28	
Filed by 30 September	4.3	43.6	4.4	44.0	3.72	39.7	3.54	37.3
Filed by 31 January	8.58	90.6	8.91	90.6	8.20	90.3	8.28	89.2
Filing Target* (93% by 2007-08)	–	90.6	–	90.6	–	90.6	–	91.5
Outstanding at 1 February	0.89	9.4	0.93	9.4	0.88	9.7	1.00	10.8

* The filing targets are for 31 January, as specified in PSA1,4 (Spending Review 2004). The 2003-04 filing target was set in Spending Review 2002.

Source: HM Revenue & Customs

It has also been recognised that achievement of the Department's filing target of 93 per cent by 2008 would be a challenge for the Department, principally because filing performance relies heavily on taxpayer behaviour and also because of the changes in criteria in April 2004 which have removed over 1.6 million taxpayers from self assessment. These taxpayers had relatively simple tax affairs and a better record for filing and paying on time.[22]

4.14 As shown in **Figure 5 overleaf**, there is significant increase in filing around the 31 January deadline, which puts pressure on the Department to process these returns. It is probably inevitable that there will always be a last minute rush whenever the deadline.

4.15 In 2008 the Department will be introducing a series of measures recommended in Lord Carter's review in 2006 of HMRC's Online Services to increase the number of taxpayers who file electronically and help to manage the peak pressures:

- the deadline for filing paper returns is being brought forward to 31 October without changing the 31 January deadline for filing electronic returns, to provide an incentive for online filing;
- the Department will withdraw approval for computer generated paper 'substitute' returns. Currently around 1.6 million 'substitute' returns for individuals are filed, almost exclusively by agents; and
- the window for the Department to enquire into returns will change from 12 months from the 31 January filing deadline to 12 months from the date the return is filed. Lord Carter considers this might remove a perceived disincentive to file returns early.

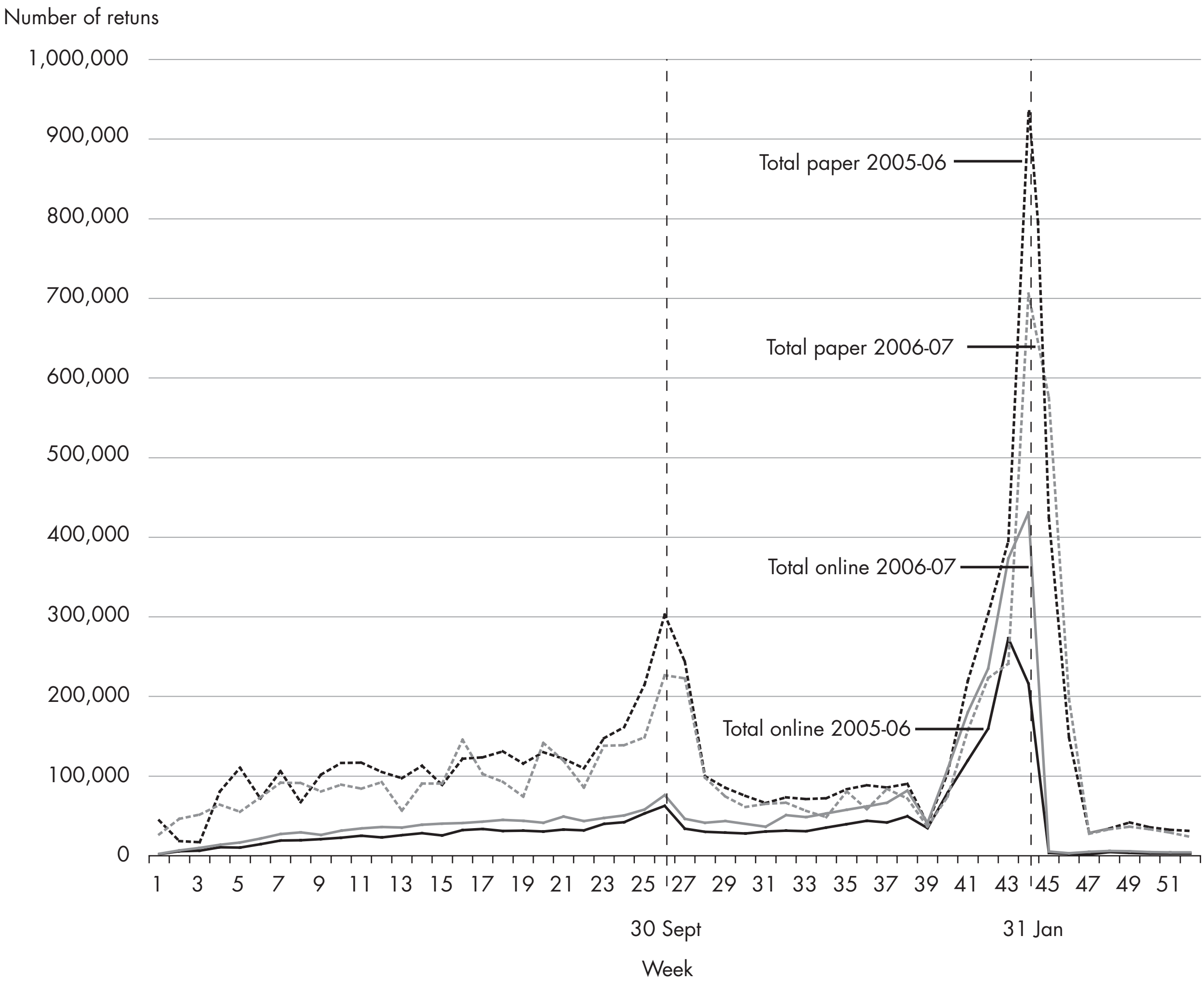
Filing returns online

4.16 In 2000 the Department introduced an internet based system for filing of Self Assessment returns. This aimed to increase the efficiency with which the Department processes returns, and free up resources from time spent on processing and error correction, to focus on more complex activities such as compliance and customer support. It also aimed to help taxpayers fulfil their obligations accurately and more quickly.

4.17 The vast majority of taxpayers have the opportunity to file their returns online for free using the Department's online product. But this only currently supports the main tax return and the most common supplementary pages. Taxpayers who are required to complete less common supplementary pages, for example those with capital gains or foreign income, do not have access to free online filing. These taxpayers have to file returns on paper or purchase third party software which supports online filing of the large majority of supplementary pages. The Department is planning to extend its online product to include the Capital Gains and Foreign income supplementary pages from April 2008. There is no online version of the short tax return but the online system does provide a tailored version of the return and taxpayers may use it as an alternative to the paper short return.

4.18 There has been a continuing increase in levels of online filing since the system was introduced and in 2006-07 2.9 million taxpayers filed their return this way. As shown in Figure 1, although the Department slightly missed its target in 2005-06, it exceeded its target in 2006-07, with 35.1 per cent of returns filed online. The Department believes this upsurge in online filing is due to:

5 Self Assessment returns filed during 2005-06 and 2006-07 by week



Source: HM Revenue & Customs

- the increased importance given to online services within the Department's marketing campaigns, both specifically for Self Assessment and the service as a whole;
- increasing reliability and resilience of the online service;
- increasing acceptance of this channel by agents; and
- the general trend for more complicated transactions being undertaken on the Internet as broadband penetration and confidence with the internet increases throughout the UK population.

Penalties for late filing of returns

4.19 In accordance with legislation, the Department has a penalty regime to deter late filing of returns. It issues £100 automatic fixed penalties to taxpayers who submit their returns after the filing deadline. If the return is filed late, the Department will cap this penalty to nil if it is established there is no tax liability or if a repayment is due. The penalty will also be capped to the amount of liability due if this is less than £100. A second automatic £100 penalty is charged if a return is more than six months late. If the return is more than a year late, the taxpayer may be charged a penalty of up to 100 per cent of the tax due on the return, in addition to having to pay the tax itself. **Figure 6** shows the number of penalties issued and the amount paid since 2003-04.

4.20 An additional measure to encourage late filers to submit outstanding returns is the use of daily penalties. These penalties can be up to £60 per day for each return outstanding and are charged when the return has been outstanding for more than 12 months and the Department believes that fixed penalties alone will not result in someone filing their return. The Department can also impose a determination (estimate) for an outstanding return and daily penalties can be raised where the determination is paid but the return remains outstanding. The Department seeks approval to apply daily penalties from the General Commissioners on a case by case basis. Since October 2003 the Department has pursued almost one million returns through the daily penalty process, as shown in **Figure 7**. In the period from October 2003 to March 2007 the number of daily penalties raised was 153,105 which has generated additional Tax of £329 million.

4.21 After gaining approval from the Commissioners, the Department warns taxpayers that daily penalties will be imposed if they do not file returns within 14 days. In 306,444 cases the threat of imposing daily penalties by the issue of a letter was sufficient to bring in outstanding returns without having to resort to actually imposing penalties.[23]

Processing Self Assessment returns

4.22 The Department processes all self assessment returns to establish if taxpayers have paid the right amount of tax and to recover additional amounts due or to repay any overpayment. It also updates taxpayers' records and, in PAYE cases, individuals' tax codes to ensure that the right tax is deducted from employees' future earnings. This process is largely automatic where returns are

6 £100 automatic late filing penalty notices

	2003-04	2004-05	2005-06	2006-07
Number of penalties issued*	1,640,267	1,715,775	1,658,883	1,735,241
Penalties capped (£0 - £99.99)	932,168	980,913	1,056,212	916,565
Penalties cancelled on appeal	215,851	233,731	190,407	152,795
Penalties after capping and cancellation on appeal	492,248	501,131	412,264	665,881
Amounts received at October Balance Date**	£37.7m	£37.3m	£39.4m	Not yet known

* These figures include second automatic penalties.

** Amounts received cover penalties issued for all years and all penalty types.

Source: HM Revenue & Customs

7 Self Assessment – daily penalties

	Returns pursued through daily penalty process	Returns received following notification of intention to impose daily penalty	Returns where daily penalties were imposed	Additional Tax generated £ million
2003-04 (October to March)[1]	183,236	82,263	10,416	50
2004-05	304,792	198,597	37,451	111
2005-06	261,066	195,691	59,154	96
2006-07	220,561	149,636	46,084	71.6*
Total	**969,655**	**626,187**	**153,105**	**328.8**

* Part year to January 2007 due to the yield reporting process.

Source: HM Revenue & Customs

NOTE

1 HMRC did not hold data linking returns received and tax assessed to daily penalties raised prior to October 2003 and the extent to which daily penalties were paid prior to this.

received through the internet, but the majority of returns are still submitted on paper and staff need to manually enter the information from these into the Department's computer systems. If the Department spot an obvious mistake, such as arithmetical errors or carry forward of the wrong figure from one box to another when processing the return they will repair it.

4.23 The Department operates a Quality Assurance/Quality Control improvement process to help managers in processing offices to identify the causes of errors, take action to prevent them recurring and help staff learn and improve.

4.24 In addition, the Department has also stepped up its monitoring of processing accuracy. Its Quality Monitoring Exercise (QME) is an independent monthly check on a sample of work across all processing offices to ensure they meet national standards. The results provide managers with timely information on performance, highlighting areas of weakness. It also provides an indication of the effectiveness of the QA/QC arrangements. From November 2005 the Department has performed its monitoring of Self Assessment processing through QME on a monthly basis, rather than on an annual basis as in previous years. The Department has taken a number of steps to improve the accuracy of its processing of Self Assessment returns. In 2005 it introduced a coding tool to reduce the need for manual calculation of tax codes and improve accuracy in coding.

4.25 The Department's QME data show that since 2001-02 the accuracy rate for processing Self Assessment returns has ranged between 72 and 75 per cent, including tax and non-tax errors. From 2004-05 processing accuracy has improved and in 2006-07 the Department achieved processing accuracy of 78.1 per cent; this was however short of its target of 84 per cent.

4.26 Processing accuracy rates have been much higher when assessed against their tax effects. In 2006-07 the Department accurately processed 96.5 per cent of Self Assessment returns, compared to its target of 97 per cent. Extrapolated across all Self Assessment returns filed, this indicates that around 300,000 returns were processed with some level of error by the Department in the tax due. The Department estimates that the gross value of errors in tax assessments resulting from internal inaccuracies in processing filed returns was £198 million (£54 million undercharges and £144 million overcharges). These amounts are reduced to £79 million (£33 million undercharges and £46 million overcharges) following the correction of errors and likely corrections for cases which are subject to ongoing correspondence or further review.

4.27 The Department has also embarked on an initiative within local offices known as 'Lean', as part of its Processing Pacesetter Programme. This aims to increase efficiency by eliminating duplication or reworking, improving accuracy, increasing productivity and reducing processing times. One significant aspect of this initiative is the introduction of quality checks by managers to identify errors before they impact on the taxpayer. In 2006 and 2007, following a successful pilot involving three large processing offices, the Department has been rolling out "Lean" to other offices.

4.28 My report on HMRC: Accuracy in Processing Income Tax [HC 605, session 2006-07] examines in greater detail the Department's levels of accuracy in processing Income Tax, the causes of errors and their impact, and changes underway in the Department to improve the accuracy of processing.

Enquiring into Self Assessment returns

4.29 Those taxpayers who are required to file a return are responsible for providing the Department with complete and correct information about their tax affairs in their annual return. The Department has a statutory right to enquire into any return and it can open an enquiry into a return at any time within one year from the filing deadline of 31 January. From April 2008 the window for opening an enquiry will change to one year from the date the return is filed. For returns filed late, it has up to 15 months to open an enquiry. After this, the Department cannot amend the taxpayer's self assessment, unless new facts come to light, undisclosed in the tax return, which show that insufficient tax has been paid.

4.30 The Department performs "full enquiries" or partial enquiries on aspects of certain Self Assessment returns. Full enquiries cover all parts of a return. Most of these are selected following a risk assessment, but the Department also randomly selects around 6,000 returns each year for a full enquiry. "Aspect enquiries" focus on specific elements of a return. There are mandatory reviews for returns with certain features, although the vast majority are chosen following a risk assessment. If a return appears fundamentally incorrect after an aspect enquiry has been opened, this may be converted to a full enquiry.

4.31 **Figure 8** shows the results of the Department's compliance enquiries. The Department has reduced the number of enquiries undertaken in recent years, as part of the development of its wider risk strategy and risk assessment processes. The Department aims to focus on the non compliant and reduce administrative burdens on compliant taxpayers and has increased total and average yields from its work. The increased yield from aspect enquiries in 2006-07 relates in part to the settlement of enquiries into a number of Employee Benefit Trust cases. Full enquiries generate higher yield than aspect enquiries, but are more resource intensive to undertake. The Department can learn about trends in non-compliance from analysis of enquiry results but for a fuller understanding it needs the results of the random enquiry programme.

Tax at risk from inaccurate returns

4.32 The Department assesses the accuracy of filed returns through an annual random enquiry programme. Based on the latest results available from the programme for 2001-02, 67 per cent of returns were filed accurately by registered Self Assessment taxpayers, slightly under the Department's target of 70 per cent. The Department estimates this meant that between £2.5 billion and £3.2 billion tax was at risk in 2001-02 due to inaccurate returns. As shown in **Figure 9**, levels of non-compliance have been stable over recent years, with approximately one third of taxpayers not fully complying with their obligations each year.

4.33 The results of the random enquiry programme suggest that each year around 15 per cent of taxpayers are non compliant by less than £500, as shown in Figure 9. But the extent of non compliance greater than £1,000 has been gradually increasing and 13 per cent of taxpayers were non compliant by more than £1,000 in 2001-02, although some of the increase is due to increases in incomes. Further analysis of the results indicates that around five per cent of Self Assessment taxpayers account for three quarters of the tax at risk. Furthermore, some 40 per cent of the tax at risk is due to one per cent of Self Assessment taxpayers.

8 Self Assessment compliance enquiries

Enquiry type	2003-04	2004-05	2005-06	2006-07#
Full enquiries				
Actual	42,000	38,000	34,000	29,000
Yield*	£194m	£200m	£221m	£278m
Average yield per case	£4,619	£5,263	£6,500	£9,586
Aspect enquiries				
Actual	176,000	159,000	139,000	132,000
Yield*	£274m	£320m	£355m	£788m
Average yield per case	£1,557	£2,013	£2,554	£5,970

Figures for 2006-07 not yet finalised.

* Yield is shown in HM Revenue & Customs Annual Report.

Source: HM Revenue & Customs

9 The Self Assessment Random Enquiry Programme

Measure	1998-99 %	1999-2000 %	2000-01 %	2001-02 %
Compliant	67	69	68	67
Non compliant, of which non-compliance by value:	33	31	32	33
£1 to £500	18	15	15	15
£501 to £1,000	5	5	5	5
over £1,000	10	11	12	13
Total tax at risk per annum	£3.1 bn	£2.4 bn	£2.7 bn	£2.8 bn

Source: HM Revenue & Customs

4.34 My staff examined a sample of enquiries conducted by the Department and found that these involved a detailed examination of the risk of non-compliance. But the random enquiry programme covers only registered taxpayers, and is not intended to provide an estimate of under-declared income from people working in the informal economy or taxpayers who are engaged in other employment for which they are not declaring their income. My staff noted that the Department's teams also identify taxpayers who made errors in their returns which result in them paying too much tax, but the Department does not provide an analysis of the number of taxpayers affected in this way or quantify the amounts involved.

4.35 The usefulness of the information from the random enquiry programme is limited by the time required to complete the work and produce results. This lead time is because the Department can only open an enquiry when a return has been filed and even a straightforward case can take several months to conclude as individuals need sufficient time to provide information. Some of the more complex cases can take several years to complete, but are more likely to be non compliant and are therefore needed to establish overall levels of error.

4.36 In the absence of up to date information on the overall levels of non compliance, it is more difficult for the Department to assess the overall effectiveness of its enquiry programme or its more recent initiatives to combat risks on certain taxpayer groups. The Department is currently reviewing the work it carries out on random enquiries with the aim of ensuring that the resource involved in examining these cases is being used as effectively as possible.

Helping Self Assessment taxpayers pay the right tax

4.37 The Department provides help and advice for taxpayers in completing and filing their Self Assessment return. Taxpayers can use the Department's website to obtain information and ask questions using structured enquiry forms, or contact telephone call centres and help lines for assistance with queries and to seek advice. They may write to their own tax office or make an appointment to visit an enquiry centre to discuss their Self Assessment return and seek advice. The Department has published guidance to accompany the tax return and further material such as "Self Assessment – your guide" to answer likely questions, which is also available on the website.

Complex Personal Tax teams

4.38 The Department has established specialist teams to provide a tailored approach to certain sectors of the Self Assessment population. It has established Complex Personal Tax teams which deal with individuals with complex tax affairs and also inward expatriate employees and their employers.

4.39 In 2003, the Department created Complex Personal Return (CPR) Teams to deal with the tax affairs of individuals with both a high level of income (over £200,000 per annum) and some element of complexity about their Self Assessment tax returns. Examples of complexity include high levels of income from land and property, high levels of foreign income, and large capital gains. The teams deal with all aspects of the customer's personal tax affairs including processing, correspondence and enquiries. Each customer is allocated a personal caseworker who will deal with their tax affairs and act as the first point of contact between the Department and the customer or the customer's adviser. In 2003-04, Complex Personal Return taxpayers represented less than 0.5 per cent of all Self Assessment taxpayers, but provided over 10 per cent of the tax collected through Self Assessment.

4.40 These teams undertake a more rigorous examination of Self Assessment returns received, which is designed to reflect their complexity. Before April 2007, every CPR tax return received an annual compliance and risk review, which was used to decide whether an enquiry or other intervention is required. This process forms part of the Department's risk assessment and is unique to CPR teams. From April 2007 following a restructuring exercise, the Department has created a central risk team within its Complex Personal Tax teams which is responsible for running projects to identify high risk returns that require a full manual risk assessment. But each return will still be risk assessed (as part of an annual risk review) at the capture stage. The NAO found that the yield generated from this work demonstrated the impact of dedicating more resource to undertaking rigorous risk assessments at an early stage and carrying out more detailed and effective enquiries on individuals with complex tax affairs

4.41 In 2003, the Department also created specialised teams to deal with the tax affairs of inward expatriate employees and their employers. The Department considers these individuals need specialist attention because they may have complex and substantial remuneration packages and the tax at stake is relatively large. Decisions on taxation can also depend on foreign legislation and on interpretations of treaties between countries.

4.42 The Department generates yield as a result of undertaking detailed enquiries on returns. As shown in **Figure 10,** yield has increased significantly since these teams were created and they have exceeded their targets. This has arisen from better targeting of work and increased staff resources, which allows more thorough and larger numbers of enquiries.

Other initiatives to improve compliance

4.43 In 2004, the Department introduced a new initiative (Minor Queries) whereby it proactively contacted certain taxpayers or their agents by telephone with queries on returns submitted. In addition to correcting obvious errors where the right answer is clear, it makes calls to clarify entries on the return – for example illegible entries or transposed figures, or a misunderstanding of the purpose of boxes in the return – in order to correct minor mistakes. These early interventions are intended to correct errors without the need for a formal enquiry and the resolution of these queries can result in adjustments in favour of either the taxpayer or the Department. The Department estimates that this initiative generated £36 million in the three years up to March 2007, against its target of £78 million. A number of factors contributed to the shortfall. Initially there were delays in getting staff in place and training them and a new information system was needed to manage their work. More significantly, responsibility for doing the work transferred to processing staff who were not responsible for meeting the yield target. In May 2007 the Department streamlined the process for correcting obvious or minor errors to allow compliance teams to examine cases in a more structured way.

4.44 The Department is increasingly using leverage letters to encourage taxpayers to comply with their obligations. These involve writing in advance to selected groups of taxpayers to highlight common errors or reacting to more specific issues that may emerge from their returns. By subsequently monitoring these individuals the Department can measure the effectiveness of each campaign and target its action towards those individuals who remain non compliant. In 2005-06 the Department issued 171,859 leverage letters (117,280 letters in 2004-05) which generated yield of £17 million (£7 million in 2004-05). The Department also considers that such letters generate a 'correction' effect in the following years as taxpayers are more likely to comply in the future.

4.45 The Department operates a statutory penalty system to discourage taxpayers from submitting incorrect returns. It can charge the full amount of the error as a penalty, although the Department often uses abatements depending on the seriousness of the offence. But the penalty charged is effectively open to negotiation which inevitably leads to inconsistency. In recent years the level of abatements has risen and there is little difference between penalties for neglect and more serious cases of fraud. The Department has also found that whilst the arrangements are understood by tax advisers, they are not visible or easily understood by taxpayers. In the 2007 Budget the Government announced a new approach to penalties for incorrect returns.[24] This aims to make a clear distinction between those who make a genuine mistake – who will not incur a penalty – and those who deliberately understate their tax liability.

4.46 The Department has received information about certain offshore bank account holders with UK addresses and has evidence to suggest that a number of these people have not declared the source of the income or the interest as taxable income. In April 2007, the Department introduced a disclosure facility which encourages voluntary disclosure of such offshore bank accounts. Where taxpayers meet the terms of this facility, tax penalties are limited to 10 per cent of the tax due. The Department has also indicated that it will continue to make enquiries based on this information in cases where a voluntary disclosure is not made. The Department is unlikely to seek penalties of less that 30 per cent where irregularities are established.

10 Specialist Teams Enquiry Performance

	2003-04	2004-05	2005-06	2006-07
CPR Teams				
Target Yield	Not set	£54 million	£77 million	£134 million
Actual Yield	£36 million	£56 million	£78 million	£197 million
Expats Teams				
Target Yield	N/A	£24 million	£47 million	£80 million
Actual Yield	N/A	£25 million	£57 million	£102 million

Source: HM Revenue & Customs

Reform of the Construction Industry Scheme

4.47 In 1972, the Government established a special tax deduction scheme to deal with the practice, endemic in the construction industry, of engaging workers on a "cash in hand" basis. A revised Construction Industry Scheme was introduced in 1999, but this suffered from problems and businesses were concerned about the costs to them of operating it.

4.48 The Department introduced changes to the Construction Industry Scheme (CIS) in April 2007, which mean that:

- Subcontractors will no longer be required to present cards or certificates to a contractor in order to be paid. On engaging a subcontractor who has not been paid by them in the current or previous two tax years the contractor must contact the Department to ascertain whether the subcontractor should be paid gross or net (and at what deduction rate).
- The contractor will make payment to the subcontractor in accordance with the net or gross instructions given by the Department.
- Contractors will submit monthly returns to the Department listing all payments, whether gross or net, made to subcontractors and including a declaration that the subcontractors listed are not engaged under contracts of employment.
- Where the subcontractor has been paid under deduction, the contractor must provide him with a statement confirming the amounts paid and deducted.
- Contractors can now use electronic channels for meeting their CIS obligations.

4.49 The Department's intention is that the new scheme will reduce the burden of operating the scheme on the construction business, improve the industry's compliance with its tax obligations and help the industry get the employment status of its workers right.

Making tax repayments

4.50 Repayments arise when the tax paid - on account or by deduction at source (for example through PAYE) – exceeds the individual's tax liability. In 2005-06 £4.2 billion repayments were made to some 2.7 million Self Assessment taxpayers.

4.51 Self Assessment repayments are generated automatically following the processing of the Self Assessment return. They are subject to routine automated checks and in certain cases or areas of particular risk the Department may specifically verify the repayment before it is made.

4.52 A lack of formalised accountabilities historically made it difficult for the Department to establish central oversight and responsibility over repayments. As I noted in my 2004-05 report on the accounts of the Inland Revenue, no individual in the Department had overall responsibility for repayments and no individual was specifically responsible for repayments under each tax stream. Deficiencies in management information also made it difficult to establish the degree to which controls could prevent or detect error and irregularities. As a result, in 2005 the Department established a Departmental Steering Group, chaired by the Director of Finance. Progress in making improvements has been slower than anticipated and the Department is now reviewing the existing governance arrangements for repayments and has initiated work to develop options for improvement. But the new integrated governance arrangements for Self Assessment have clarified accountability for repayments.

4.53 In the spring of 2006 Internal Audit reported that there were continuing weaknesses in the Department's operation of self assessment repayment processes. They found that in 2004-05 the Department's calculations of amounts to be repaid were incorrect in 11 per cent of cases. Extrapolating the results of their sample, Internal Audit estimated that taxpayers had been overpaid £176 million and underpaid £34 million. In response to these problems, the Department has established new arrangements to provide assurance that Departmental instructions are being followed by staff.

Unsolicited Self Assessment returns

4.54 Some taxpayers submit Self Assessment returns to the Department even though none has been requested. This is usually because they have a new source of income or a chargeable gain during the year. The Department receives over 200,000 "unsolicited returns" each year.

4.55 The Department has evidence of organised criminal activity to obtain fraudulent repayments, some of which have involved "unsolicited returns". Since the Department first became aware of these systematic attacks it has disrupted one particularly virulent example which involved 50 purported tax agents, 14,000 false Self Assessment returns and potentially £34 million in false repayments.

4.56 The Department is seeking to counter the known attacks. It has created an Income Tax Self Assessment Repayments Delivery Group to design and implement process and other changes to reduce risks to the repayments process and develop specific interventions to counter remaining risks. In April 2007, the Department introduced changes to enable processing staff to identify unsolicited returns more easily so that in appropriate cases they can be closely checked before any repayment is made. The Department is also reviewing the effectiveness of its existing automated checks on repayments to better identify high risk repayments for further checking, and is considering using enhanced risk profiling for repayment fraud using data from different Departmental systems. The Department has informed me that it recognises the need to be vigilant given the constant changes in the methods used to perpetrate organised fraud and that it is committed to fully engaging with HM Treasury to ensure a joint understanding of the potential Exchequer risks.

Collecting Self Assessment Debt

4.57 Taxpayers are usually required to make two payments on account based on their tax liability for the previous year. The first is payable by 31 January before the end of the current tax year and the second by 31 July after the end of the tax year. Any outstanding balance of tax is payable by the following 31 January. Some taxpayers, such as employees who pay most of their income tax through PAYE, are not required to make payments on account and have only to pay any outstanding balance of tax by the following 31 January.

4.58 If a taxpayer fails to file a return, the Department can issue a determination estimating the amount of tax to be paid.

4.59 In 2006-07, 88.5 per cent of Self Assessment taxpayers paid the amounts owed on time, against the Department's target of 89.8 per cent. The Department considers that it did not achieve its target because some of the individuals removed from Self Assessment had a better record for paying on time, as noted in paragraph 4.13. Furthermore increasing number of self employed taxpayers have been brought into Self Assessment and the Department's experience is that those new to the system tend to be less compliant. In 2007-08, the Department plans to further develop its operational targets for reducing debt.

4.60 The Department charges interest and surcharges where tax is paid late. Interest is charged on any tax not paid at the 31 January payment date. A five per cent surcharge is also payable on any tax which remains unpaid at 28 February. The Department imposes a further five per cent surcharge on any remaining tax outstanding after 31 July.

4.61 **Figure 11** provides an analysis of the age of self assessment debt at 31 March 2007. The vast majority of debt has been outstanding for more than two months. The Department is satisfied that the proportion of debt outstanding for more than one year is being actively managed through legal proceedings, agreed arrangements to pay debt over time and through its efforts to trace individuals.

4.62 As shown in **Figure 12**, average monthly Self Assessment debt increased from £2.7 billion in 2004-05 to £3.1 billion in 2006-07. The Department considers that this increase is due to:

- economic growth, which has resulted in higher levels of underlying Self Assessment receipts; Self Assessment receipts have risen from £23.4 billion in 2005-06 to £26.6 billion in 2006-07;
- increased use of determinations (estimated tax demands) in an attempt to secure returns and payment from non-payers and non-filers; and
- the recent transfer of Self Assessment debt into the Department's automated debt management systems means that it issues determinations much earlier than it had been able to do so in the past and some amounts are reflected in the debt balance much sooner.

11 Self Assessment Debt Age Profile at 31 March 2007

Age of Debt	Debt £bn	Proportion %
Less than 2 months old	0.18	5
Between 2 & 12 months old	1.99	56
Greater than 12 months old	1.41	39
Total	3.58	100

Source: HM Revenue & Customs

12 Self Assessment Debt

Year	Self Assessment Receipts £ bn	Average Monthly Debt £ bn
2004-05	21.84	2.68
2005-06	23.43	2.89
2006-07	26.59	3.13

Source: HM Revenue & Customs

4.63 If a taxpayer disputes an amount due under Self Assessment then the Department suspends this debt from collection. If the taxpayer has a legal right on appeal to apply for postponement of the amount due, then the Department records this as a formal standover. The Department also can informally standover debt, where circumstances require a temporary suspension of enforcement action. As shown in **Figure 13**, the value of stoodover debt has also steadily increased over recent years. This growth has arisen for the same reasons that have driven the overall growth in self assessment debt levels. At the end of October 2006, over £1 billion was in dispute and was not legally collectible. Of this, £502 million has been stoodover for more than two years and £216 million over one year.

4.64 A recent analysis of amounts stoodover has shown there were some 85,000 cases of stoodover tax totalling £1.113 billion at May 2007. 114 of these items relate to some £500 million of tax, almost half of the total amount stoodover. The Department is taking action on these and a high percentage are with its Special Civil Investigations Office.

4.65 In 2006, Internal Audit examined the Department's arrangements for reviewing stoodover debt to see if they were being examined regularly by the Department and concluded there was a high risk that the Department's work in this area was not being progressed in a timely and appropriate manner. In addition to the risk of poor service to the taxpayer, delays in processing stoodover debt can make it harder for the Department to subsequently collect debt and potentially lead to a loss of revenue. Internal Audit plan further work in 2007 to quantify the full financial risk.

4.66 The Department has sought to improve Governance in these areas. It has set up a cross Departmental working group tasked with specifically reviewing stoodover debt. This aims to improve the measurement of stoodover debt, develop targets and plans to reduce it and confirm it is being correctly treated and subject to regular management review.

Conclusions

4.67 Self Assessment was introduced in 1996 for taxpayers with a number of sources of income and with less straightforward financial affairs. It now affects 8.7 million self employed and higher rate PAYE taxpayers, 570,000 partnerships and 225,000 trusts. In 2006-07 the Department collected £26.6 billion tax through the system, after repayments. In 2006-07, 88.5 per cent of Self Assessment taxpayers paid the amounts owed on time, against the Department's target of 89.8 per cent. The average monthly debt owed to the Department in 2006-07 was £3.1 billion, an increase of £250 million on the previous year.

4.68 The Department has changed the Self Assessment process to ease the burden on certain taxpayers. Since 2004-05 the Department has removed 1.6 million taxpayers with very straightforward affairs from the system, although this reduction has been largely offset by increasing numbers of self employed and highly paid employees coming into the system. In April 2005 the Department simplified the Self Assessment process for nearly 1.5 million people with simpler tax affairs by issuing a new Short Tax Return.

13 Self Assessment Tax Stoodover

Date	Self Assessment Tax due for collection £ billion	Self Assessment Tax Stoodover £ million	As a percentage of Self Assessment Tax due for collection %
October 2001	24.8	611	2.5
October 2002	26.3	595	2.3
October 2003	25.8	628	2.4
October 2004	26.7	790	3.0
October 2005	29.2	873	3.0
October 2006	30.7	1,031	3.4

Source: HM Revenue & Customs

4.69 The administration of Self Assessment involves a number of business areas within the Department, ranging from teams processing returns and undertaking compliance enquiries to collecting debt and providing computer support. In 2006 the Department established a new integrated governance structure to manage Self Assessment, which aims to improve coordination and enhance collaboration across the different parts of the Department involved in administering the process. These arrangements therefore provide a more effective basis for administering Self Assessment. But the structure does not include the Department's compliance activities over Self Assessment. The Department should consider the scope for the closer integration of compliance.

4.70 Online services offer considerable benefits in the efficient and effective administration of tax and Self Assessment has been at the forefront of the Department's drive to engage with the taxpayer through the internet. The Department has made significant progress in increasing the percentage of returns filed online and is currently meeting its target of 35 per cent of Self Assessment returns to be filed online for 2007-08.

4.71 In 2006-07 around one million taxpayers did not submit their returns by the 31 January deadline and the Department failed to meet its target that 91.5 per cent of returns were filed on time. The results were lower than those for the previous two years. The Department's early analysis suggests that this was primarily because of reduced media advertising in 2006-07 and problems with its campaign to contact taxpayers new to Self Assessment. In addition to learning from its experience in 2006-07, the Department should examine the effectiveness of the existing penalty regime and consider whether new or greater sanctions are needed to change taxpayer behaviour.

4.72 The Department operates a penalty system to discourage taxpayers from submitting incorrect returns. The Department often uses abatements depending on the seriousness of the offence, but the penalty charged is effectively open to negotiation which inevitably leads to inconsistency. In recent years the level of abatements has risen and there is little difference between penalties for neglect and more serious cases of fraud. The Department has also found that whilst the arrangements are understood by tax advisers, they are not visible or easily understood by taxpayers. In the 2007 Budget the Government announced a new approach to penalties for incorrect returns. This aims to make a clear distinction between those who make a genuine mistake – who will not incur a penalty - and those who deliberately understate their tax liability. These reforms should help the Department better tailor its approach to address the underlying taxpayer behaviour.

4.73 The Department assesses the accuracy of filed returns through an annual random enquiry programme. Based on the latest results available for 2001-02, 33 per cent of returns were filed inaccurately. The Department estimates this meant that between £2.5 billion to £3.2 billion tax was at risk in 2001-02 due to inaccurate returns. Some 40 per cent of the tax at risk relates to one per cent of taxpayers. The Department should target groups who are more prone to non-compliance, for example partnerships and sole traders.

4.74 The Department has reduced the number of compliance enquiries undertaken in recent years, although the yield generated from this work has increased. The Department has also established specialist teams to tailor its approach to the Self Assessment population, including individuals with complex tax affairs and inward expatriate employees and their employers. The yield from this work has grown consistently over recent years and exceeds the Department's targets. But not having up to date information on total levels of tax at risk reduces the Department's knowledge of overall non-compliance. The Department recognises the need to make earlier and more regular assessments of tax at risk to assess the effectiveness of its compliance activities, inform its risk assessment process and identify new areas for targeting compliance resources. The Department has formed the Risk and Intelligence Service to help take this work forward.

4.75 Self Assessment repayments are generated automatically following the processing of self assessment returns. A lack of formalised accountabilities has historically made it difficult for the Department to establish central oversight and responsibility over repayments, including the extent to which agreed controls were being operated. Deficiencies in management information have also made it difficult to establish the degree to which these controls could prevent or detect error and irregularities. The Department has evidence of organised criminal activity to obtain fraudulent repayments, sometimes using unsolicited returns. It introduced improved controls in April 2007 to specifically monitor unsolicited returns and is reviewing the effectiveness of its existing automated checks for identifying high risk repayments which require checking before they are made. It needs to closely monitor the success of these measures in deterring organised crime.

PART FIVE

Value Added Tax

Introduction

5.1 This part of the report examines the management of Value Added Tax (VAT) by HM Revenue & Customs. VAT is levied on the supply of goods and services within the United Kingdom and Isle of Man. Registered businesses incur VAT on the goods and services they purchase (input VAT) and, subject to partial exemption restrictions, can recover the cost against the VAT charged on the sale of their own goods and services (output VAT), or if there is an excess by reclaiming a repayment from the Department. VAT is, therefore, ultimately paid by the consumer. In 2006-07 net VAT revenue totalled £85.5 billion, an increase of £11.8 billion on the previous year **(Figure 1)**.[25] This was primarily due to the success of the Department's operational strategy in tackling missing trader fraud and spending growth. Of the £85.5 billion, approximately £19.0 billion came from VAT on imports.

Statutory Framework for VAT

5.2 The EU Principal VAT Directive provides the general legislative framework for European Member States to administer.[26] Member States are required to enshrine the provisions of the Directive in national law so as to ensure a harmonised approach to operating VAT systems across the European Union. In the United Kingdom these basic rules are implemented by the Value Added Tax Act 1994 (as amended).

1 Annual VAT Yield Figures

Year	Net VAT Yield (£ billion)
2003-04	71.1
2004-05	74.2
2005-06	73.8
2006-07	85.5

Source: HMRC Annual Accounts

5.3 Under the VAT Act 1994, traders are required to register for VAT if their taxable business turnover has exceeded a defined threshold in the previous twelve months, or is expected to exceed the threshold in the next 30 days. From 1 April 2007, the taxable turnover threshold for compulsory registration was increased from £61,000 to £64,000. The threshold for allowing businesses to deregister their VAT obligation also increased from £59,000 to £62,000.[27] Traders operating below the threshold can apply for voluntary registration, providing the business trades in goods and services that are 'taxable supplies' for VAT purposes (or would be taxable supplies if they were carried out in the UK). Similarly, those intending to carry on a business trading in goods and services that would be 'taxable supplies' for VAT purposes (or would be taxable supplies if they were carried out in the UK), can also apply for registration.

5.4 Member States may set the level of their standard rate of VAT, subject to a minimum of 15 per cent. They may also apply either one or two reduced rates of VAT on a range of specified goods and services, subject to a minimum of five per cent. In addition, the UK is able to maintain a zero rate of VAT provided for under special transitional provisions dating from the introduction of VAT in the UK. There are currently three rates of VAT applicable in the UK:

- a standard rate of 17.5 per cent charged on the supply of all goods and services unless specifically relieved;
- a reduced rate of five per cent which applies, for example, to supplies of domestic fuel and power, certain renovation and alteration of dwellings, residential conversions and the installation of energy-saving materials; and

- a zero rate which applies, for example, on the supply of items such as food, passenger transport, books and printed matter, and children's clothes.

The Directive also provides for certain exemptions from VAT. Examples of VAT exemptions in the UK are: finance; insurance; education; and health and welfare.

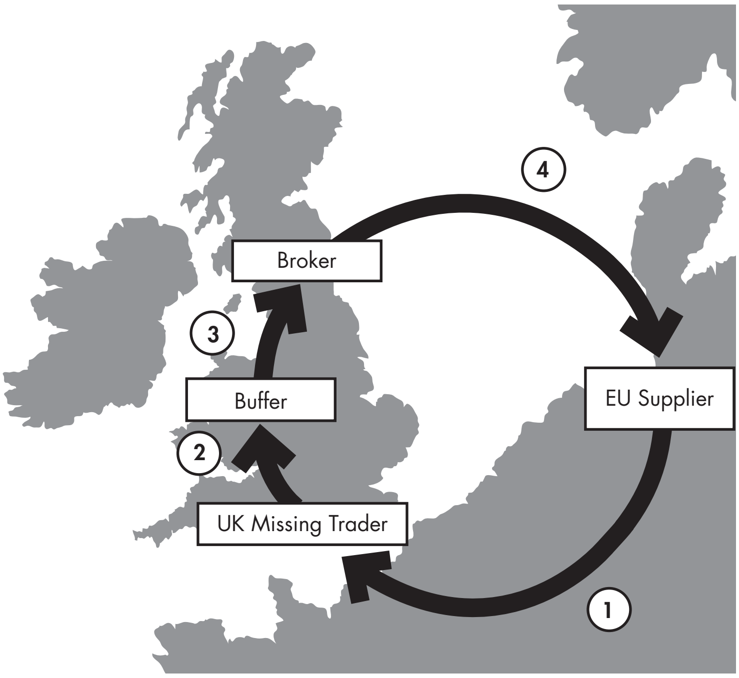
Developments on Missing Trader Fraud

5.5 This section provides an update on how the Department is tackling missing trader fraud.[28] In its simplest form the fraud involves a business obtaining a VAT registration number in the UK for the purpose of purchasing goods, VAT free, from other EU Member States. The business then sells the goods at a VAT inclusive price in the UK and disappears without paying the VAT to the Department. In its most abusive form, commonly referred to as carousel fraud, traders sell the same goods repeatedly through contrived supply chains involving other traders in both the UK and other Member States of the European Union **(Figure 2)**.

5.6. The Department has been tackling missing trader fraud since 2000. Its early strategy focussed, among other things, on registration checks, targeted compliance visits, criminal investigations targeted at the organisations that are persistently attacking the VAT system, and working with the European Union and other international partners to raise awareness of the fraud and to improve information exchange and cooperation. Despite these measures, the level of attempted fraud reached a new peak in 2005-06 when the Department estimated it at between £3.5 billion and £4.75 billion. However, as a significant proportion of these attempted frauds were stopped, the actual cash loss was estimated at between £2 billion and £3 billion.[29] The Department, in response to the increase in fraudulent activity, introduced further operational and legislative interventions to strengthen the strategy.

5.7 During 2006-07 the Department re-deployed 700 staff to verify a greater proportion of VAT repayment claims received from traders suspected of participating in missing trader fraud. Using a risk based approach, the Department's aim is to only repay those amounts due to be paid, and to deny repayments where there is no entitlement or that entitlement is disallowed due to knowledge of fraud in supply chains. The Department's position was strengthened by the European Court's judgement in the 'Kittel' case, where the Court ruled that VAT repayments could be denied where there was evidence that the trader knew or should have known that the transactions formed part of the overall scheme to defraud.[30] The Department's operational indicators show that this, together with other measures, has significantly reduced attempted fraud in 2006-07.[31]

2 An example of a simple VAT missing trader fraud chain



1. An EU supplier from another Member State sells goods for £1,000,000 to a trader based in the UK free of VAT. Sales of goods between VAT registered companies in the EU are zero-rated for VAT.

2. The trader sells the goods to another trader commonly known as the buffer at a reduced price of £900,000 plus £157,500 VAT. In order to avoid the price of the goods spiralling upwards each time the carousel turns, one business in the chain must sell at a loss. Following an intensive period of trading the initial UK trader goes missing without paying the VAT due to HMRC.

3. The buffer accounts for VAT correctly and sells the goods to a trader at the end of the UK chain, termed the broker, for £950,000 plus £166,250 VAT.

4. The broker makes a zero-rated VAT sale back to the original EU supplier for £970,000 and is entitled to reclaim the input VAT of £166,250 on the goods purchased from the buffer. HMRC pays the claim and incurs a cash loss because the missing trader did not pay the VAT due on the sale to the buffer.

Source: National Audit Office

5.8 Around 95 per cent of traders whose returns have been selected under the current verification programme, have been found to be either participating in or profiting from trading linked to missing trader fraud. Repayment claims have either been identified as not properly being due, or because of sufficient suspicion are continuing to be investigated. Moreover, so far only one per cent, by value, of the VAT withheld under this programme has been found to be correctly claimed and properly payable. The Department can, whilst the verifications are being undertaken, make repayments if security or a bank guarantee is provided. Additionally, repayments can be made on transactions which are clearly not linked to fraudulent activity, e.g. business overheads.

5.9 In December 2005 the Government submitted a request to the European Commission to derogate from the Sixth VAT Directive and introduce a 'reverse charge' on goods commonly used in missing trader fraud, such as mobile phones and computer parts together with other electronic goods, for example MP3 players and digital cameras. Under this measure VAT would not be charged on the sale of these goods between businesses. Instead VAT would only be collected on retail sales to final consumers, therefore removing the opportunity for criminals to engage in missing trader fraud. The European Commission supported the application and agreed that the reverse charge should be applicable until 31 December 2009.

5.10 In April 2007 the Council of the European Union authorised the Government's request to introduce the 'reverse charge'. However, it is only applicable until 30 April 2009 at which point its continued use will be reviewed by the Commission.[32] In addition, the scope of the derogation is limited to sales, over £5,000, of mobile phones and computer chips.[33] Prior to its introduction on 1 June, the Department provided advice and worked closely with traders to facilitate the transition. It is now estimated that the measure will lead to an increase in VAT receipts of £135 million in 2007-08, compared with the original estimate of £500 million.[34] This is because the:

- Department's current operational strategy has succeeded in dampening down the level of attempted fraudulent activity since the derogation was originally applied for;
- scope of goods covered by the derogation is not as wide as originally envisaged; and
- financial effect of the reverse charge was originally calculated on the basis that the reverse charge would commence from 1 January 2007.

5.11 As the 'reverse charge' will apply only to specific products, fraudsters may switch to other goods not covered by the measure and therefore limit its effectiveness. An extension of the reverse charge could be sought, should these mutations arise. The Department, however, recognises that effective monitoring of trading activity will prove crucial in tackling any mutations and preventing an escalation of fraudulent activity in other areas.

5.12 The Government announced, in Budget 2007, its intention to extend the list of goods covered by Joint and Several liability actions under section 77A of the VAT Act 1994, which was enacted in May 2007. The measure which applied previously to telephones, computers and their parts, now includes a variety of electronic equipment and accessories. Under this measure a VAT registered business can become liable for VAT due from another trader in the supply chain if the business knew or had reasonable grounds to suspect that VAT amounts were going unpaid elsewhere in the chain. The Department aims to use this measure more extensively, should the fraud mutate to other goods not covered by the derogation.

5.13 In addition to preventing future losses, the Department's heightened compliance activity in tackling the fraud has identified a significant amount of VAT debt owed by fraudsters. The deployment of additional staff in 2006-07 to tackle (disrupt) missing trader fraud has resulted in an increase in the number and value of VAT assessments issued, and hence debts being reported. As a consequence, the level of debt related to missing trader fraud has risen from £687 million in 2005-06 to £2.3 billion in 2006-07.

5.14 The Department does not, however, pursue this debt until the outcome of any criminal action is known, which because of the complexity of the investigations, may take several years to conclude. Where these actions are successful, the criminal assets are seized and the sums assessed are written off. In non-criminal cases involving missing trader fraud, the Department will either deregister the defaulting business or use the insolvency rules to transfer control of the business from a potential fraudster to a licensed insolvency practitioner. This approach prevents more significant losses and, in some cases, provides a means of securing the personal assets of individuals behind the fraud. In cases where there is an immediate risk of significant asset dissipation, the Department may apply to the High Court to appoint a provisional liquidator to close down the company immediately.

5.15 In 2006-07, 210 traders involved in missing trader fraud were made insolvent as a result of Department action. The Department also initiated provisional liquidation action against 11 businesses and approximately £0.7 million has been recovered and a further £2.9 million in assets have been secured. Furthermore, there are 115 missing trader cases, with debts totalling £557 million, where insolvency action is currently ongoing. Debts may be written off in other cases which are not subject to insolvency or the criminal asset recovery process and where there is no prospect of recovering the tax owed.

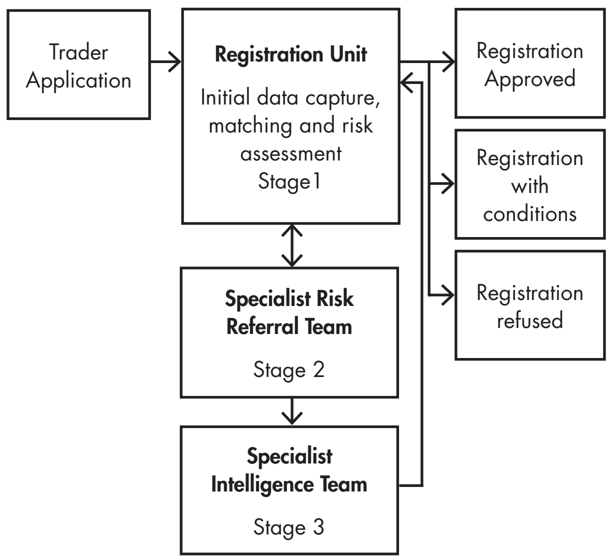
5.16 Organised criminals currently exploit EU VAT rules, which allow intra-Community goods to be traded VAT-free. The Department's current operational measures have successfully reduced the level of attempted fraudulent activity. However, missing trader fraud is a European Union wide problem, estimated at £40 billion (€60 billion), which can only be successfully tackled with the co-operation of other European Union Member States.[35] The Department should, therefore, continue to work with other Member States in identifying and tackling these criminals, and seek a long term solution to the problem, which may include an overhaul of the current VAT system. However, any changes would need to reduce considerably the possibilities for missing trader fraud, exclude any opportunities for new types of fraud, and not generate a disproportionate administrative burden for traders and the authorities.

VAT Registration Checks

5.17 VAT registration is the entry point for businesses to the VAT system. The National Registration Service is responsible for ensuring that registration applications, de-registrations and amendments are processed promptly and accurately. In line with the Department's commitment to help taxable persons to meet their obligations, the Service aims to support the needs of customers, provide advice and guidance, and ensure that processes are effective to meet demand. This customer-focused approach is also balanced against the requirement to reduce VAT fraud levels. Legally, the Department cannot refuse to register a business if its taxable turnover exceeds (or will exceed) the registration threshold (as per paragraph 5.3). However, it has the right to refuse a VAT application from an intending trader or one seeking voluntary registration, if it has reasonable grounds to suspect that the applicant is or is likely to be involved in fraudulent activities.

5.18 The Department continues to face attacks against the VAT system from criminal networks orchestrating missing trader (and other forms of) fraud. Preventing criminals from entering the VAT system is critical in tackling both missing trader and labour provider (gang-master) fraud, as outside the VAT system they cannot perpetrate the fraud.[36] All applications are subject to an initial, semi-automated risk assessment process to identify potential fraudulent applications; the first of potentially three levels of checking, determined by the risk they represent, as shown in **Figure 3**. As a result of this initial (stage 1) risk assessment, the Registration Units will, where necessary, contact traders to ask for further information before continuing the application process. This occurs, for example, where the application is incomplete or unclear; or evidence of intent to trade or of economic activity is needed to make the risk assessment decision. Most applications, approximately 95 per cent, require no further risk assessment and are processed accordingly. Around five per cent of all applications are referred to specialist risk advisors (stage 2), and just one per cent are further referred to a specialist intelligence team (stage 3). Where the registration unit does not have sufficient evidence to refuse an application but still has suspicions about a trader, it can impose conditions on the registration, such as requiring a financial guarantee or shortening the first VAT period to enable the Department to make an early assessment of compliance.

3 Registration process



Source: National Audit Office

NOTE

For 2006-07, Registration Units were based in Carmarthen, Grimsby, Newry and Wolverhampton. By April 2008 it is anticipated that two units will remain: Grimsby and Wolverhampton.[37] All applications are subject to validation checks to identify potential fraudulent applications. High risk applications (representing around five per cent of all applications) may be referred to the Risk and Intelligence Teams for further examination.

5.19 Prior to 2005-06, registration applications identified as high risk were sent direct to the specialist intelligence team for further detailed checking of trading activity and individuals involved in the business. However, in order to enhance the timeliness of the processing procedures, experienced missing trader officers were re-deployed, on a part-time basis, to each of the Registration Units to act as missing trader risk advisors. As well as speeding up the risk decision process the risk advisors acted as a filter for applications referred to the Intelligence Team. In September 2006, following a review of procedures, the Department decided to restructure the risk advisory function and established a centralised pre-registration risk referral team under the control of the Risk and Intelligence Unit. The Department saw the move as an opportunity to create a dedicated team that will be able to develop expertise in high-risk VAT registration applications.

5.20 The use of the risk advisors has enhanced the quality of the risk assessment process and led to a significant increase in the number of suspect applications either being refused or registered with specific conditions. In 2006-07 the total number of missing trader applications refused or registered subject to conditions was 4,382 and 2,320 respectively. In addition, 1,691 labour provider (gang master) applications were refused **(Figure 4)**. This reflects the Department's efforts to prevent abuse of the VAT system by traders who are intent on registering only to commit fraud.

5.21 The Department has noticed following the introduction of tighter pre-registration controls that fraudulent traders are attempting to circumvent checks by acquiring VAT registered businesses, which are then used to trade in goods normally associated with missing trader fraud. In response, the National Registration Service has developed additional risk checks and issued fresh guidance to help registration teams identify such activity and protect the VAT system. In 2006-07 the Department refused 177 suspect amendment requests.

Registration Performance Targets

5.22 In 2006-07 the National Registration Service processed 285,176 new applications. Some 20 per cent of these applications were received electronically, compared with 13 per cent in 2005-06, the first full year in which the Department made e-registration available **(Figure 5)**.[38] Increased awareness of e-VAT services among the trader population has led to improved take-up levels.

5.23 The National Registration Service has an internal performance target for the time taken to process VAT applications. Up until 2005-06 the service had performed well against a target of processing 95 per cent of complete and accurate applications within 15 days of receipt; with 94 and 97 per cent reported in 2004-05 and 2005-06 respectively. However, for those applications that were not complete and accurate, processing times could have

4 Registration checks and outcomes

	2004-05	2005-06	2006-07
New registration applications received	269,515	284,804	285,176
Missing Trader Applications			
New applications subject to detailed checking by specialist risk and intelligence teams	4,573	8,672	10,635
New applications refused on suspect grounds[1]	1,866	2,271	4,382
Businesses registered with specific conditions	151	1,230	2,320
Labour Provider Applications			
New applications subject to detailed checking by specialist risk and intelligence teams	N/A[2]	1,189	809
New applications refused on suspect grounds[1]	N/A[2]	1,242	1,691
Businesses registered with specific conditions	N/A[2]	446	247

Source: HM Revenue & Customs

NOTES

1 Includes suspect fraudulent applications refused by the Registrations Units without referral to risk and intelligence teams, and those refused following further checks.

2 Data collection commenced in 2005-06.

5 VAT registration

	2004-05	2005-06	2006-07
Number of new registration applications received	269,515	284,804	285,176
Percentage of applications received electronically	0.1%	13.0%	20.0%[1]
Percentage of complete and accurate registrations processed within 15 days [Target 95%]	94%	97%	N/A[2]
Percentage of registrations processed within target – 14 days [Target 30%]	N/A[2]	N/A[2]	27%
Percentage of applications received that were complete and accurate [Target 50%]	27%	27%	49%

Source: HM Revenue & Customs

NOTES

1 My Report on "Helping new businesses meet their tax obligations" published on 6 December 2006 indicated a take up of 16 per cent for the period April to July 2006. The take-up for the full year had increased to 20 per cent.

2 For 2004-05 and 2005-06 the Department operated to a performance target reflecting the percentage of complete and accurate registration applications processed within a target of 15 days. In 2006-07 the Department set a new target of processing 95 per cent of all applications within 14 days by the year 2008. The interim measure for this target was 30 per cent by year-end March 2007.

been considerably longer where additional information was required. The average time taken to process 95 per cent of applications was 29 days. Some five per cent of applications are subject to detailed anti-fraud checking, which in 2006-07 frequently delayed processing by up to 12 weeks. To ensure that processing is more customer-focused, the Department set a new target of processing 95 per cent of all applications within 14 days by the year-end March 2008. The interim measure for this target was 30 per cent achievement by the year-end March 2007. Of the 285,176 applications received, 27 per cent were processed within the target date (Figure 5).

5.24 The Department aims to ensure that 50 per cent of applications for registration are complete and accurate.[39] Around 49 per cent were complete and accurate in 2006-07 compared with 27 per cent in 2005-06 (Figure 5). My report on "Helping new businesses meet their tax obligations" explained that the low accuracy rates were mainly due to the relatively complex VAT registration form compared to the registration forms businesses must submit for other taxes.[40] This is because the business completing the VAT registration form needs to understand both technical terms and complex concepts.

5.25 Some of the information that the Department asks for on the form is to help the registration units identify applications that come from fraudsters trying to enter the VAT system. The Department recognised that for the majority of businesses the registration form should be simplified, and undertook to redesign it as well as provide clearer and more focussed guidance to help businesses complete it. The Department issued a new paper-based VAT registration form in December 2006 and has used its website to notify prospective applicants of common mistakes in filling out the forms. The new VAT registration form is simpler and more user friendly. To achieve this, some questions have been deleted and new questions added, and the order rearranged to make more logical sense sequentially.

5.26 A 'Registration Working Group' was set up in September 2006 to coordinate efforts for improving customer service. The Group has helped promulgate revised guidance for businesses, as well as remove the requirement to provide, as standard, intending trading evidence. It also initiated a comprehensive review of the registration risk referral process in March 2007. The Department expects that implementing the review recommendations will help to improve processing timescales. In addition, it is developing a new computerised risk engine which will automate and enhance the current manual registration risk assessment process undertaken by the Registration Units.

Validation and Credibility Checks on VAT Returns

5.27 The 1.9m VAT registered businesses submit almost eight million VAT returns each year, of which 8.6 per cent were filed electronically in 2006-07 **(Figure 6 overleaf)**. The majority of registered traders file returns quarterly, usually one month after the end of the quarter. However, some returns are also submitted on a monthly or annual basis.

6 VAT tax returns filed

Year	Returns received (millions)	Returns completed electronically	Percentage of returns filed electronically
2003-04	7.4	14,000	0.2
2004-05	7.8	86,000	1.1
2005-06	7.8	380,000	4.9
2006-07	7.9	677,000	8.6

Source: HM Customs & Excise

NOTE

The VAT returns received figure is based on businesses who file monthly, quarterly and annually. It also includes changes through new registrations and de-registrations.

5.28 The majority of processing for VAT returns is completed at a single site (Southend), where, following post opening and validation (where basic manual checks are carried out on all returns), the returns are microfilmed. Whilst being microfilmed, the cameras pick up information from the bar code on the return and transmit an early message to the VAT Mainframe to note that a return has been received (to stop erroneous enforcement). The VAT return is then passed to the VAT Data Capture Unit where the data is entered onto the VAT Mainframe, the core computer system the Department uses for managing VAT. The returns are subsequently subjected to automated completeness and accuracy checks. Errors and omissions are identified and referred to the Accounting & Adjustment Team (Liverpool) for further checking and correction. All repayment returns are subject to credibility checks before they are authorised for payment. Outstanding debts are pursued by the Department's Debt Management Units **(Figure 7)**.

5.29 To provide assurance that VAT repayment claims from traders are legitimate and accurate, the Department uses computerised credibility checks to assess the claims against a set of variable parameters. These checks are intended to direct early attention to inconsistencies in traders' returns. They also complement the risk-based programme of assurance visits to traders' premises. Claims which fail the credibility tests are classified into those that must be checked before any repayment is made (pre-repayment credibility queries) and those where the repayment can be made prior to further checks (post-repayment credibility queries).

5.30 The Department's VAT Credibility Operations Unit, based in Liverpool, scrutinises the pre-repayment queries. Those queries that it cannot resolve, together with queries down-graded to post-repayment status, are referred to local offices for further examination. In 2006-07 the credibility checks selected 218,860 returns for further checking, representing 10 per cent of all repayment returns received. Of these, 177,241 (£25 billion) were selected for pre-repayment verification and 41,619 (£1.74 billion) for post-repayment verification. As a result of these checks it was found that some repayment claims had been overstated by a combined total value of £603 million (£497 million in 2005-06), either through error or fraud.

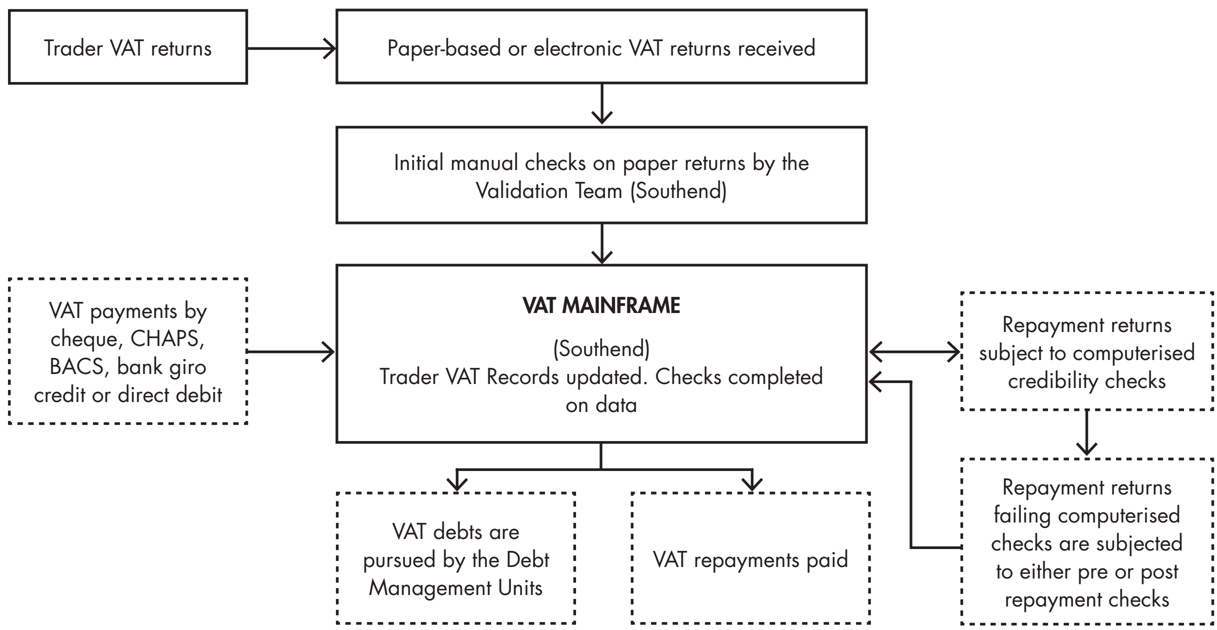
5.31 The Department will pay a repayment supplement of five per cent of the value of the claim or £50, whichever is the greater, if authorisation of the repayment is unreasonably delayed beyond 30 days. In 2006-07 it achieved its published target to authorise at least 90 per cent of correct repayment returns within 10 working days.[41] At the same time, the Department makes it clear to businesses that it will carry out checks and apply safeguards to ensure that claims are legitimate and accurate.

5.32 In 2006-07 the Department paid £8.68 million in repayment supplement **(Figure 8)**, of which a significant proportion, i.e. £3.9 million, comprised:

- £1.8 million (£1.6 million in 2005-06) which the Department had to pay following the judgement by the European Court of Justice (ECJ) in the Bond-House case, where the ECJ concluded it should not have withheld VAT repayments, and[42]
- £2.1 million (£1.4 million in 2005-06) paid to traders following the verification of VAT repayments undertaken as part of the Department's strategy in tackling missing trader fraud.

5.33 The supplement also includes £728,216 which was incurred following a systems error.[43] In August 2006, the system responsible for capturing electronic data from local VAT offices failed to transfer information to the VAT mainframe and, in turn, update a number of IT suites essential to performing the majority of VAT business activities. Whilst a number of business areas were affected during this time, particular disruption was caused to completing pre-repayment credibility operations. The problem led to a total downtime of six calendar days. The Department has now implemented rigorous daily checks to ensure that a similar system problem does not recur, and has acknowledged the weaknesses in its wider IT service level and support arrangements around this process. The Department is currently reviewing these arrangements and aims to take any necessary steps to make sure that action is taken promptly should a similar process problem arise in the future.

7 Overview of the VAT filing process

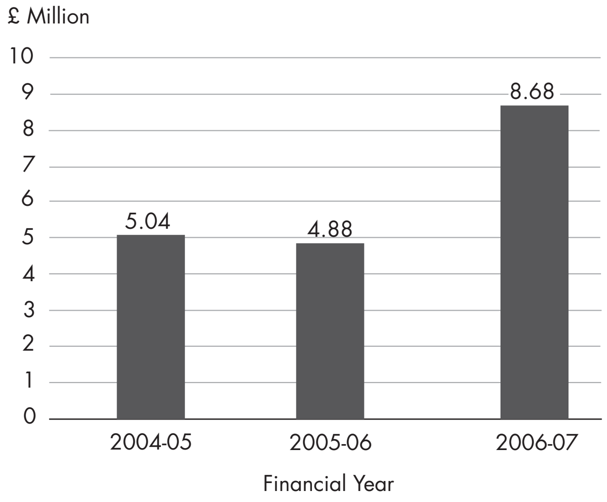


Source: National Audit Office

NOTE

The VAT Mainframe holds all the trader information needed for day to day processing. VAT returns are subject to completeness and accuracy checks both before and when entered into the Mainframe. Traders owing VAT can either pay by cheque, CHAPS, BACS, bank giro credit or direct debit. Outstanding VAT debts are monitored and collected by the Debt Management Units. Repayment returns are subject to credibility checks before payments are made.

8 VAT repayment supplements



Source: HM Revenue & Customs

NOTE

The Department pays a repayment supplement of five per cent of the value of the claim or £50, whichever is the greater, if authorisation of the repayment is unreasonably delayed beyond 30 days. In 2006-07 and 2005-06 repayment supplements totalling £1.8 million and £1.6 million respectively were paid, following the decision by the European Court of Justice in the Bond House case, that the Department should not have withheld VAT repayments.

Conclusion

5.34 The Department strengthened its operational and legislative measures to tackle missing trader fraud, following an increase in fraudulent activity in 2005-06. The United Kingdom's application for a 'reverse charge' on certain goods was approved by the Council of the European Union in April 2007 and introduced from the 1 June 2007. However, the 'reverse charge' does not extend to the whole range of electronic goods requested in the original application. It has been limited to goods commonly associated with the fraud, i.e. mobile phones and computer chips. In addition, the derogation will only be applicable for the period up until April 2009, at which time its effectiveness will be reviewed by the European Commission. There is a risk that the organised criminals behind the fraud will divert their attention to other goods not covered by the derogation. The Department, however, recognises that effective monitoring of trading activity will prove crucial in tackling any mutations and preventing an escalation of fraudulent activity in other areas.

5.35 The extended verification of repayment claims has, according to the Department's operational indicators, reduced the level of fraudulent activity in the UK. However, missing trader fraud is a European Union wide problem as fraudsters exploit EU VAT rules that allow intra-Community goods to be traded VAT-free. The Department should, therefore, continue to work with other Member States in identifying and tackling these criminals, and seek a long term solution to the problem, which may include an overhaul of the current VAT system. However, any changes would need to reduce considerably the possibilities for missing trader fraud, exclude any opportunities for new types of fraud, and not generate a disproportionate administrative burden for traders and authorities

5.36 The Department has strengthened its registration controls to prevent fraudsters from obtaining a VAT registration number. Some five per cent of new applications (285,176 in 2006-07) are subject to detailed anti-fraud checking which in 2006-07 delayed processing by up to 12 weeks. The introduction of risk advisors at the registrations units, however, has enhanced the risk assessment process. The number of suspect registration applications refused increased from 3,513 in 2005-06 to 6,073 in 2006-07.

5.37 The processing of registration applications can be delayed if they are incomplete and/ or inaccurate. The Department has a public service agreement target to increase the number of complete and accurate applications received to 50 per cent. Through making the application form user friendly and providing focused guidance for businesses, the Department achieved an outturn of 49 per cent in 2006-07 compared with 27 per cent in 2005-06. The Department also set a new target of processing 95 per cent of all applications within 14 days by March 2008. The interim measure for this target was 30 per cent achievement by March 2007. Of the 285,176 applications received, 27 per cent were processed within the target date. However, progress will need to be significant if the Department is to achieve its 2008 target.

5.38 The Department has a responsibility for ensuring that correct VAT repayments are paid promptly. Repayment supplements amounting to five per cent of the VAT claim or £50 (whichever is the greater) is paid if repayments are not paid within 30 days of being submitted. It also has to protect VAT revenue, and therefore has controls in place to check VAT repayment claims. In 2006-07 the Department met its target of processing 90 per cent of correct repayment claims within 10 days. The checks, however, identified and prevented over-claims arising from error or fraud totalling £603 million. Repayment supplements in 2006-07 totalled £8.68 million, of which £3.9 million arose as result of the Department's measures in tackling missing trader fraud. It also included £728,216 which was incurred following a systems error that, most importantly, took six calendar days to resolve as the Department did not have in place the IT service level or support arrangements necessary to resolve the issue more quickly. The Department has implemented daily checks to ensure that a similar system problem does not recur, and is currently considering improvements to the wider service level and support arrangements around this process to make sure that action is taken promptly should a similar process problem arise in the future.

ENDNOTES

1 *"HMRC and the Taxpayer: Modernising Powers, Deterrents & Safeguards: initial consultation document"* published March 2005. *"Modernising Powers, Deterrents & Safeguards: A Consultation on the Developing Programme of Work*", published March 2006.

2 Reform of film tax incentives: Promoting the sustainable production of culturally British films, HM Treasury, July 2005.

3 Budget 2006: Regulatory Impact Assessments, Chapter 3 (paragraph 3.45) published March 2006 by HM Treasury and HM Revenue & Customs.

4 Finance Act 2006 Schedule 5, paragraph 24.

5 The Films (Definition of a British Film) (No 2) Order 2006 (SI 2006 No 3430) amended the definition of a culturally British film under the Film Act 1985.

6 Finance Act 2006 Schedule 5, paragraph 24.

7 Finance Act 2006, Schedule 5, paragraph 31.

8 Finance Act 2006 Schedule 5, paragraph 19 (amending the Films Act 1985, Schedule 1).

9 Budget 2006 : Regulatory Impact Assessment : Chapter 3 (paragraph 3.55) Published March 2006 by HM Treasury and HM Revenue & Customs.

10 Code of Practice 26, What happens if we have paid you too much Tax Credits.

11 This results from overpayments for 2003-04 to 2005-06, plus £600 million overpayments identified in 2006-07 resulting from claimants reporting in year changes of circumstances. The Department will identify further overpayments for 2006-07 when these awards are finalised.

12 These estimates do not include incorrect payments found through HMRC's compliance checks as shown in Figures 5 and 6, Part 2.

13 In 2006-07 HMRC received over 50 million form P14s, including those for employments and pensions that ceased during the year. At the end of 2006-07 there were 38 million employment and pension sources.

14 In the light of further analysis of its work on multiple income sources, the Department has revised its previous estimate of overall tax at risk reported in 2005-06. HMRC's estimate of tax at risk has been revised downwards from some £1 billion of tax due not being pursued, overpayments of around £500 million, resulting in potentially 5.7 million taxpayers not paying the right amount of tax

15 The computer system automatically clears cases where the underpayment is not more than £50 or the overpayment in £10 or less.

16 The Department ignores any differences that are below £1.

17 The relevant legislation is in the Income Tax (Incentive Payments for Voluntary Electronic Communication of PAYE Returns) Regulations 2003 (SI 2003/2495)

18 The results from the QME exercise measure levels of error with HMRC's current clerical procedures. The errors identified by Internal Audit, discussed in paragraph 3.4, look at wider weaknesses in PAYE, for example the failure to process information promptly or to bring together all the relevant information on a taxpayer when calculating tax payable

19 The Department has increased its estimate of the number of open cases at the end of 2005-06 from 8.7 million to 12.2 million. The increase relates to 3.5 million unprocessed cases that arose because of computer difficulties, which the Department expected to clear promptly. But these were not cleared as quickly as the Department anticipated and Figure 4, Part 3 therefore reflects the revised estimate.

20 The Department has estimated the tax loss by examining a sample of its records. The results of the sampling provide 95 per cent confidence that the tax loss is £135 million (+ / - £85 million) and 80 per cent confidence that the tax loss is between £80 million and £190 million.

21 All partnerships are required to complete a partnership tax return. Trustees or personal representatives of a deceased person's estate where income arises on assets in the estate are required to complete Trust returns.

22 NAO Report –Filing of Income Tax Self Assessment Returns [HC 74 Session 2005-2006] 22 June 2005.

23 On average there are two returns outstanding per case. Therefore the number of returns received following notification to impose Daily Penalties shown in Figure 7, Part 4 is higher than the number of letters issued.

24 This issue is also discussed in paragraph 1.5 of my report.

25 Gross VAT Receipts £144.5 billion (£134.4 billion, 2005-06); Repayments £59 billion (£60.6 billion, 2005-06). These amounts include 4.2 billion, mainly relating to missing trader fraud, which have either been written off or recognised as doubtful debts.

26 Council Directive 2006/112/EC replaced, in a single consolidated text, the first and sixth VAT directives and subsequent amendments on 1 January 2007.

27 HM Treasury, Budget 2007 Building Britain's long-term future: Prosperity and fairness for families, Chapter A Budget Policy decisions, March 2007, HC342.

28 Report on VAT Missing Trader Fraud – HM Revenue & Customs 2005-06 Accounts, HC 1159 (R38).

29 HM Revenue & Customs, Measuring Indirect Tax losses 2006, December 2006.

30 European Court of Justice Axel Kittel v Belgian State, Case C-439/04, July 2006.

31 Estimates of VAT losses arising from missing trader fraud are published alongside the Chancellor's Pre-Budget Report. Estimates for 2006-07 are therefore expected to be published in December 2007.

32 Council Decision of 16 April 2007 authorising the United Kingdom to introduce a special measure derogating from Article 193 of Directive 2006/112/EC on the common system of value added tax.

33 Mobile phones include other communication devices, such as Blackberrys, but phones supplied under an airtime contract (but not 'pay-as-you-go' phones) will be excluded from the reverse charge.

34 Figures obtained from HM Treasury's Financial Statement and Budget Report Appendix A, Table A1.1 and HM Revenue & Customs' 2005-06 Accounts, HC 1159, R48.

35 HM Revenue & Customs 2005-06 Accounts (HC 1159) – *Report on VAT Missing Trader Fraud* (R49).

36 In a similar way that Missing Trader Fraud is committed, fraudsters operating as gang-masters charge VAT on the supply of labour, but do not declare it on their VAT return to the Department. They then disappear once significant VAT profits have been made during an intense period of trading.

37 There is a separate team, the Non-Established Taxable Persons Unit (in Aberdeen), which deals with VAT applications from businesses that are located outside the UK but which make taxable supplies within the UK and are, therefore, required to account for UK VAT.

38 Businesses have been able to register for VAT on-line since December 2004.

39 HM Revenue & Customs PSA objective III 'Improve customer experience, support business and reduce the compliance burden'; Key Indicator 4: Demonstrate a measurable improvement in (b) improving the proportion of applications for VAT registration that are complete and accurate to 50 per cent.

40 HM Revenue & Customs: Helping newly registered businesses meet their tax obligations. HC 98 Session 2006-07, 6 December 2006.

41 Notice 700/58 Treatment of VAT repayment returns and VAT repayment supplement, paragraph 5.1.

42 Judgement made on 12 January 2006 in case of Optigen Ltd, Fulcrum Electronics and Bond House Systems Ltd v Commissioners of Customs and Excise. As part of its strategy in tackling missing trader fraud, the Department withheld VAT repayments to companies on the grounds that they were part of an overall chain to defraud and that the circular sale of goods in the chain had no economic substance.

43 The total repayment supplement paid was £1.262 million, of which £534,000 was recovered.

Printed in the UK by The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office
ID5609022 07/07 19585

Printed on Paper containing 75% recycled fibre content minimum.