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HM Revenue & Customs 2005–06 Accounts

– Consolidated Resource Accounts
– Trust Statement
– Standard Report

(For the year ended 31 March 2006)

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HM Revenue & Customs 2005–06 Accounts

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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 2006 and up to the date of approval of the accounts, and accords with HM Treasury guidance.

3. Governance

3.1 The high-level governance structure that was established last year at the formation of HMRC continues to develop and to provide strategic leadership. This consists of:

- A Board that comprises the members of the Executive Committee, the Chief Executive of the Valuation Office Agency and the non-executive Board members. Its role is to set the Department's strategic direction and to provide advice to the Executive.
- An Executive Committee that is the primary decision making forum for the Department. Its members' portfolios span the whole of the Department.
- An Operating Committee that supports the Executive Committee by providing oversight of the Department's day to day performance.
- An Audit Committee that comprises non-executive Board members and provides me with advice and support in my responsibilities for risk management, internal control, corporate governance and associated assurance.

- A Corporate Responsibility Steering Group whose brief is to develop a Corporate Responsibility action plan and to oversee its implementation across the organisation.
- A People Committee that provides assurance on all aspects of people issues, ensuring that the Department's policies and systems benefit from independent views and strategic consideration at a high level.
- A Security Committee that monitors and manages HMRC's exposure to security risks and threats.
- A Senior Appointments Board that considers appointment, succession planning, and development issues relating to the Senior Civil Service.

4. Risk Management

4.1 The risk management arrangements in the Department have continued to be developed and refined throughout the year, as the new business model (see paragraph 5.1) and supporting processes bed in.

Capacity to handle risk

4.2 The Executive Committee takes an active role in shaping the Department's risk management arrangements, determining the risk priorities, and reviewing progress in managing the risks in the Strategic 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.

4.3 The Audit Committee, supported by Internal Audit and informed by the outcomes from the work of National Audit Office (NAO), plays a key role in reviewing our governance and risk arrangements, and is a catalyst for ensuring that we continue to adapt and improve these.

4.4 We have set up a network of key individuals across HMRC whose day to day roles involve advising managers and staff on governance and risk management. This helps ensure a shared understanding across the Department of risk management principles and practices, and identify and share examples of good practice.

The risk and control framework

4.5 A new HMRC risk management framework has been put in place. The framework, which is available to all staff through our intranet, sets out the principles, processes and accountabilities for risk management in HMRC.

4.6 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 (see paragraph 5.2). These Director-level risks inform the strategic risk management process, which is focused around the Strategic Risk Register. Ownership of the risks in the Strategic Risk Register is assigned at Executive Committee level, and at the next level of management down – the Delivery Manager.

5. Control

5.1 I reported in the 2004-05 Inland Revenue and HM Customs and Excise Statements on Internal Control that I had put in place a new business model designed to produce a balanced organisation requiring collaborative working across and between its different elements, for which clear accountabilities have been introduced. This model continued to develop throughout 2005-06. Crucial to the success of this model are the 36 Directors who, as well as being responsible for managing risk and delivering results in their own individual areas, also contribute towards the shared responsibility and joint problem-solving that are necessary for genuine transformation of the Department. Monthly meetings of all Directors, together with the Executive Committee members, provide the opportunity to discuss key strategic issues, and recent decisions taken by the Executive and Operating Committees.

5.2 The primary way in which Directors give an account of their performance is through the Quarterly Performance Reporting process that I have instigated. Using standard performance report templates that tie in with the Management Accounts, Directors provide a commentary on performance against plans, and the likely end year position, based on underlying data. These reports are then the subject of performance conversations between the Director and the relevant Executive Committee member, with the Finance Director also attending. The focus of the conversation is on the progress being made in each Director's area to deliver added value and on the key issues and risks that could prevent the achievement of key targets and objectives or the establishment of a new HMRC culture and behaviours. Feedback from the series of performance conversations as a whole is then discussed at the Executive Committee.

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

- A Governance Champion has been appointed in our centralised and distributed processing areas. The primary focus of this role will be to provide a coherent structure for Governance across our processing functions and to review its effectiveness.
- A Criminal Justice & Enforcement Standards Unit has been established to define and monitor professional standards across HMRC's enforcement activities and related high-risk areas. The new unit will bring together and rationalise the work of the separate teams that previously provided an independent professional standards and assurance function to managers within HM Customs and Excise Law Enforcement and the Special Compliance Office within Inland Revenue.
- In November 2005 a number of working groups, committees and structures led by the Tax Credits Programme were replaced by a new governance structure, headed by the Tax Credits Strategic Group. The group is chaired by the HMRC Deputy Chairman. A Tax Credits Co-ordination Manager ensures that all activity is co-ordinated and supports the high level aims and objectives of the tax credits system.
- To enable better understanding of the threat posed by tax avoidance and enable prioritisation of HMRC's response, the Anti-Avoidance Group has developed a register of avoidance schemes and arrangements that enable cross-Departmental collaboration in the deployment of resource and appropriate tactics in dealing with individual schemes. This register has ensured that HMRC has improved understanding of the risk to the Exchequer posed by schemes and arrangements.

- We have created new finance posts in the business to improve communications and raise financial and performance management standards. Most of the 36 Directorates now have a Finance Business Partner (FBP), a single point of contact for the Directorate providing advice, support, challenge and assurance to Directors. FBPs are responsible for working with their Director to develop appropriate performance measures for their business, which tie in with the performance reporting process and the Management Accounts.

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 weekly Executive Committee meetings. These meetings are informed by an assessment of our current exposure to risks associated with our major programmes and projects. I also receive detailed, monthly Management Accounts, which highlight potential areas of concern and I meet Directors individually to discuss performance.

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.

Update on issues raised in 2004-05 Inland Revenue (IR) Statement

Tax Credits: Fraud and Claimant Compliance

6.5 The Comptroller and Auditor General (C&AG) has again given a qualified audit opinion on the Department's Trust Statement in view of the level of claimant fraud and error in this area. Details of this qualification can be found in the C&AG's Certificate & Report on the Trust Statement. The overall level of error and non-compliance across the tax credits population, including the financial consequences of that non-compliance, is published in note 3.4 of the Trust Statement. HMRC continues to develop its strategy to further identify areas of risk; to improve compliance; and to identify and counter fraud.

6.6 The Department continues to deploy resources against the highest risks and looks to strike the balance between effective checking before payment is made and a minimum of delay in genuine claimants receiving their awards. All new claims are subject to automated risk assessment and verification processes using data from systems across HMRC and Department for Work and Pensions. Stringent checks seek to identify and exclude fraudulent claims before payments are made, although the Department is still subject to attack by fraudsters who acquire 'stolen identities'. Additionally, we operate robust processes to intervene and terminate claims where there is evidence of potential organised fraud. This action is fully supported by legislation and claimants' appeal rights are not compromised. It is also proving to be a cost effective means to protect the Exchequer. As a result of the risk to the Exchequer and the sustained attack on the system, the E-portal, for making tax credit claims over the Internet, was closed on 2 December 2005 to prevent further abuse and loss. Options for the possible reintroduction of this service are being considered.

Tax Credits: Accounting and Reconciliation

6.7 Although systematic reconciliation from employers' end of year tax details to actual amounts authorised for payment to employees has not been achieved, the Department seeks to ensure that the amount paid is correct by selecting a statistically valid sample of employer records and manually reconciling the amounts paid. We have a robust process that is independently monitored by Internal Audit. Reconciliation conducted last year for payments made in 2004-05 showed a reconciliation rate of 77.4 per cent compared with the rate of 78.9 per cent for payments made in 2003-04. A similar exercise has just started for payments made in 2005-06. However, this does not constitute an on-going risk, as all Payment via Employer (PVE) claimants will have transferred to direct payments from HMRC by early 2006-07, and this is the last time that this exercise will be undertaken.

6.8 New functionality was introduced in November 2005 which automates the daily reconciliation of payments made against payments authorised. Any details that cannot be matched promptly are reported to operators for investigation and, where appropriate, correction of the tax credit record. The function continues to identify reconciliation errors on a daily basis. Where a discrepancy is discovered that is not suitable for operator correction, it is referred to Aspire, our strategic IT partner, and prioritised for system fixes.

Tax Credits: Software Errors

6.9 The level of software error in the tax credits system reflects its complexity and relative immaturity, in particular the level of development that is continuing to take place on what is still a fairly new system. In general, errors, when they occur, now only affect a minority of customers. All errors are prioritised for analysis and fixing. Work started in October 2005 to review systematically all open problems and calculate the potential financial exposure in terms of overpayments and underpayments to inform the Departmental accounts. This work is on track to be finished in Summer 2006.

Pay As You Earn (PAYE)

6.10 The IR Statement on Internal Control for 2004-05 commented on weaknesses identified by reviews of PAYE business, particularly where the system dealt with instances of employees having more than one job. These weaknesses are estimated to have led to overpaid tax of £295 million and underpaid tax of £575 million.

6.11 The Department set up a Steering Group to prioritise the recommendations from these reviews and is undertaking a number of health checks and risk assessments across the range of PAYE operations. In response to the recommendations made in these reviews, the Department has taken steps to ensure staff better understand the need to use all relevant sources of information when reviewing liability, so that underpayments and overpayments of tax can be identified and collected or repaid. All agreed recommendations have either been fully actioned or plans to implement them are in development.

6.12 Looking ahead, further work under the Modernising PAYE Processes for Customers (MPPC) programme will bring together information for each taxpayer about all their sources of PAYE income and is expected to reduce inaccuracies significantly. From April 2007, information about different sources of income 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 and increase the automation of processing onto the National Insurance (NIRS) system, which will then progressively become the main system which holds and processes PAYE information.

Class 2 National Insurance 'Debt' Balances

6.13 A cross-Departmental working group has been looking at the outstanding debt on the Class 2 National Insurance system. When HMRC is notified that a person is self-employed, we assume that they continue to be liable for Class 2 National Insurance until we are told otherwise. As a result, some of the debt balance on the system will be false due to a failure to notify cessation.

6.14 We reported last year that £616 million of Class 2 debt was over 6 years old as at 6 April 2005 and therefore time-barred. £333 million was estimated as time-barred true debt and formally written-off in the 2004-05 accounts. The remaining £283 million was considered not to be true debt and has been waived.

6.15 The Department has addressed the ongoing issues by:

- Identifying and prioritising the £71 million 1999-2000 estimated true debt, which without action would have become time-barred in April 2006. This has included work to trace missing contributors and prioritise for enforcement action. The true debt balance has now reduced by £8.2 million to £62.8 million.
- Developing a strategy to clear debt balances from the systems in a timely fashion.
- Reviewing the end to end Class 2 National Insurance processes to see whether any cost-effective changes could be made which would improve the position in future. Work continues on this aspect.

6.16 A Director-level group oversees these actions and reports to the Operating Committee.

Update on issues raised in 2004-05 HM Customs and Excise (HMCE) Statement

Missing Trader Intra-Community (MTIC) VAT fraud

6.17 Issues around this aspect of the VAT Compliance Strategy were reported in the HMCE Statement on Internal Control for 2004-05, when the fraud was estimated to have cost between £1.1 billion and £1.9 billion. In response to changes in the nature of the fraud and indications of significant increases in trading in high risk areas during 2005-06, HMRC has taken urgent steps to strengthen its strategy by a combination of operational initiatives focusing on key points in MTIC supply chains and a tougher litigation strategy, including criminal prosecutions designed to increase the risks for the fraudsters. In addition, the Government has requested a derogation from the Sixth VAT Directive in order to introduce a reverse charge VAT accounting system for goods commonly used in MTIC 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 MTIC goods in a business-to-business transaction. As this is done on the same VAT return in which it is claimed back, it effectively removes VAT from the transaction chain. The Government also announced, in the Budget, further legislative measures targeted at those involved in MTIC supply chains. New governance arrangements have been put in place to drive through these changes and to ensure that the strategy continues to evolve quickly to take account of future changes in MTIC fraud.

6.18 Following a European Court of Justice (ECJ) decision in January 2006 we have developed a methodology for establishing whether a trader had knowledge or means of knowledge of the fraud within their supply chain. All the cases that have been awaiting the decision of the ECJ have been reviewed in the light of guidance provided by this ECJ ruling, to establish whether or not the business in question is entitled to its VAT repayment. HMRC has continued to disallow the input tax where there is evidence that the conduct of the business requires this, within the context of the ECJ test ruling. This approach is also being applied to other large claims for input tax from businesses trading in MTIC supply chains.

Recent Court Cases

6.19 In light of the judgements by Mr Justice Crane in the MTIC-related case of Operation Venison (and by the Court of Appeal in the cases of Operation Hellvellyn and others), the Paymaster General announced in Parliament that HMRC had agreed with the Independent Police Complaints Commission that they would oversee an investigation into the criticism of actions of individual officers. That investigation is ongoing and HMRC has addressed the continuing position of the officers involved. The Paymaster General also announced that HM Inspectorate of Constabulary would begin in September 2005 a full programme of inspection to examine informant handling, controlled deliveries and disclosure procedures, including the issues raised in the judgements mentioned above. That programme is also ongoing.

New issues raised in 2005-06

PAYE: Operations of Benefits in Kind

6.20 Continuing reviews of PAYE business have identified further weaknesses in the Department's handling of benefits in kind information, also leading to significant losses of tax. It is estimated that 1.9 million taxpayers may be affected, with potential tax of £181 million overpaid and £519 million underpaid. The underlying problem is similar to that described in paragraph 6.11 above – that information from employers is available within the Department but is not being used in finalising liability or updating tax codes early enough to avoid the case needing clerical action at the year end to calculate an under or overpayment. The Department is looking at options for a risk-managed approach to information so that resources can be assigned to cases where the likelihood of a significant adjustment being needed is highest – whether in the customer's favour or HMRC's. This area has been identified as one of the top priorities for 2006-07 and staff have been provided with an IT tool which calculates the correct code based on the information available. The accuracy of work on benefits in kind should start to show significant improvements once information from employers starts to flow through in the Summer of 2006. From April 2007, we expect to introduce IT support to update tax codes automatically to reflect the latest information from employers, further improving accuracy and reducing the number of open cases i.e. those needing to be reviewed after the year-end.

PAYE: Open Cases

6.21 Additional resource has been invested in dealing with open cases to reduce numbers to a manageable level. A number of steps have been taken to improve the quality of work, including earlier and more frequent work checks to identify errors and misunderstandings so they can be rectified more quickly. This and other initiatives will have a positive impact on in-year accuracy and so reduce open cases at the year-end 2005-06 and onwards. But software and other technical difficulties encountered with mandatory e-filing of employer end of year returns have delayed the posting of data on to the Department's main National Insurance and PAYE systems. Accordingly current open case numbers are higher than we would otherwise have expected.

Consultancy

6.22 During the year Internal Audit (IA) highlighted problems with the procurement of consultancy services, in respect of non-adherence both to public procurement rules and recommended governance processes. This issue was brought to the attention of the Executive Committee and the Audit Committee.

6.23 We have identified the reasons which led to these problems and analysed our total consultancy spend. The analysis showed that well over half the expenditure was under Office of Government Commerce (OGC) and other framework contracts, with the most significant area potentially affecting value for money being standalone contracts where the value of non-competed awards amounted to £4.8m. Measures introduced since to ensure that, in future, there are tighter governance arrangements over spending on consultancy, include:

- Ensuring that by Autumn 2006, fully compliant contracts are in place for all consultancy expenditure;
- Using the new Enterprise Resource Planning system, an integrated accounting and resources package, to enforce authorisation levels;
- Reviewing invoices, to provide an assurance that future spending on consultancy is made using these fully compliant contracts.

6.24 The Executive Committee and the Audit Committee will be updated on the effectiveness of these measures.

HMRC Efficiency Programme

6.25 HMRC has a number of programmes and projects in place aimed at delivering the efficiency savings and relocations from London and the South East to which we are committed. These are overseen by a Departmental Efficiency Programme Board. In December 2005 an OGC review assessed the overall programme and the likelihood of delivery of all of its targets as 'provisional red', i.e. requiring urgent and decisive action. OGC commented that the Department deserved credit for the progress it had made in a number of areas during a period of organisational change. They were concerned, however, that there was not enough evidence of overall control over the range of programmes and projects and they made a number of recommendations for a reorganisation of the management of the change programme.

6.26 In the light of the December 2005 assessment a "Joint Priority Review" of the Efficiency Programme was undertaken by OGC and HMRC. The key recommendations concerned governance and programme management. As a result the Executive Committee agreed revised terms of operation for the Programme Board providing:

- Clear lines of accountability.
- Frequent reporting to the Executive Committee on progress towards targets and milestones by enabling programmes and Directorates.
- Mechanisms for assessing the effect of failure or slippage in any part of the programme on the totality of the expected benefits.

- Identification and active management of cross cutting risks and dependencies.
- A programme office that collates information, scrutinises plans and reports and provides 'first line' conflict resolution between constituent programmes.

6.27 A further OGC assessment was completed in June 2006. This assessed the programme overall as "Amber Red". OGC have acknowledged that they have increased confidence in the Department's ability to deliver its efficiency targets. They also note improvements in governance and programme management, but report that these need to be continued and sustained as the programme moves forward.

Tax Repayments

6.28 Reviews by NAO and IA of repayments made in 2004-05 have identified a number of weaknesses in the operation of controls on the issue of repayments of Self Assessment (SA) tax and PAYE.

6.29 In 16 per cent of PAYE cases reviewed by IA, they could find no supporting paperwork against which to check the accuracy of the repayment. For those cases that they were able to check, they found that calculations of the amounts to be repaid were incorrect in 7 per cent of PAYE cases and 11 per cent of SA cases. Extrapolating the results of their sample check, IA estimate that, potentially, 400,000 customers have been paid too much, with amounts overpaid of £176 million for SA and £27 million for PAYE. And potentially 173,000 have been paid too little, with amounts underpaid of £34 million for SA and £11 million for PAYE.

6.30 I recognise that we need a strategic response to address these problems. We have therefore set up a Repayments Steering Group, chaired by my Finance Director, to co-ordinate and oversee a range of measures to improve our performance in making repayments to customers. The issues identified are already being addressed, including reminding staff of the importance of following the correct repayment processes and retaining the supporting papers.

Sir David Varney
Principal Accounting Officer
6 July 2006

Resource Accounts

Consolidated Resource Accounts for the year ended 31 March 2006

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The Annual Report

Scope of these Resource Accounts

As Chairman and Principal Accounting Officer for HM Revenue & Customs (HMRC) I am pleased to present the Resource Accounts for the year ended 31 March 2006. Following the Chancellor's announcement in his March 2004 budget speech, legislation to create the Department received Royal Assent on 7 April 2005 and HMRC became a legal entity on 18 April 2005. The new Department, HM Revenue & Customs, 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. These Resource Accounts report on the first financial year of HM Revenue & Customs, and include income and expenditure relating to the Core Department and the Valuation Office Agency (VOA).

HM Revenue & Customs 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). 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 75 to 106 of this publication.

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 in these Resource Accounts.

Departmental Reports

The Department produces regular reports on its performance which appear as part of the Annual and Spring Reports. The HMRC Annual Report 2004–05 was published on 19 December 2005 (Cm 6691) and the Spring Report 2006 was published in June 2006 (Cm 6832). The next HMRC Annual Report will be published later this year. Departmental reports are available from The Stationery Office and the HMRC website (www.hmrc.gov.uk). Details of the Valuation Office Agency's objectives and performance can be found in its Annual Report and Accounts (HC 1141), which is available from The Stationery Office and the VOA website (www.voa.gov.uk).

No significant company directorships or other interests were held by Board members which may have conflicted with their management responsibilities.

Auditors

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 (2004-05: £0.5m). 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 2005-06 the cost of the audit of the Trust Statement amounted to £1.2m (2004-05: £0.5m). As a result the total audit fee reported in these Resource Accounts is £1.9m (2004-05: £1.0m).

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.

Executive Committee and Departmental Board

During the year ended 31 March 2006, the Chairman of the Board of HM Revenue & Customs was accountable to the Chancellor of the Exchequer for the administration of its affairs and the implementation and stewardship of tax policy. The Chancellor was supported by the Paymaster General, Dawn Primarolo MP, who was the Departmental Minister with day to day responsibility for HM Revenue & Customs. The general direction and priorities for the Department were set out in the remit letter issued to the Chairman by the Chancellor of the Exchequer on 7 April 2005.

During the year, the composition of the Executive Committee of HM Revenue & Customs was:

		(Period – if not full year)
Sir David Varney *	Chairman (Permanent Head of Department)	
Paul Gray CB *	Deputy Chairman	
Dave Hartnett CB *	Director General	
Helen Ghosh *	Director General	to 31 October 2005
Steve Heminsley	Acting Director General	
Steve Lamey *	Chief Information Officer	
Stephen Jones *	Finance Director	
Mike Eland CB *	Director General	
David Hogg CB	Acting Solicitor & General Counsel	
Mike Hanson MBE *	Director General	
Bernadette Kenny	Director General	from 23 September 2005

* Commissioners of HM Revenue & Customs

Ann Chant CB was a Commissioner and member of the Board of Inland Revenue until 18 April 2005 and David Garlick OBE was a Commissioner and member of the Board of HM Customs and Excise until 18 April 2005.

The following non-executive Board members, together with the Executive Committee members and Andrew Hudson (Chief Executive of the Valuation Office Agency), formed the Departmental Board.

Bill Griffiths	Non-executive Board member	
Mark Haysom	Non-executive Board member	from 1 December 2005
Nick Macpherson	Non-executive Board member	
Penny Melville-Brown	Non-executive Board member	from 1 January 2006
Kate Owen	Non-executive Board member	
Barry Quirk CBE	Non-executive Board member	
John Spence MBE	Non-executive Board member	from 1 September 2005
David Spencer	Non-executive Board member	

All of the non-executive Board are considered to be independent. Nick Macpherson, as Permanent Secretary to HM Treasury, has a clear and acknowledged relationship with HMRC. Nevertheless, in his non-executive role, he is considered to be independent in character and judgement.

Management Commentary

The Department's aim and objectives for 2005-06 were:

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.

Objectives

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.
2. Improve customer experience, support business and reduce the compliance burden.
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.

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).

Structure of the Department as at 31 March 2006

In March 2004, the Government accepted in full the recommendations of the review of the Revenue Departments, led by Permanent Secretary to the Treasury, Gus O'Donnell. The key recommendation of the review was the creation of the new Department. The merger of the Inland Revenue (IR) and HM Customs and Excise (HMCE) will allow the new Department to meet its efficiency target to reduce staffing levels by 12,500 by 1 April 2008 whilst delivering our goals of improving customer services, reducing compliance costs, and increasing efficiency.

The reporting of performance will be enhanced with the introduction in 2006-07 of a new financial/HR system, Enterprise Resource Planning (ERP), to provide a single source for financial, people and procurement information, supporting better resource deployment and decision making. Other benefits from the investment in ERP include effective investment and performance monitoring and reduced back office costs.

Prior to the launch of HMRC we had designed a structure for the new organisation, and in April 2005 we set up the Business Design Programme to support the senior managers of the Department as they implemented that design. By the end of December 2005, we had restructured the Department into 36 units, agreed accountabilities and key interfaces for those units, designed and trialled new management processes to underpin the structure, and built understanding and alignment across the senior management team. The Business Design Programme, having completed its work of ensuring the key elements of the design were in place and operating effectively, has now been closed. Remaining work on implementing the design principles at lower levels is integrated with normal business, with oversight by HMRC's Operating Committee, and reviews led from the Change Management Centre.

The 36 business units, sitting under four business areas and overseen by the Executive Committee, are:

- The Customer business areas, comprising Large Business & Employers, Small & Medium Enterprises and Employers, Individuals, Frontiers;
- The Operations business areas, comprising Customer Contact, Centralised Processing, Distributed Processing, Intelligence, Debt Management and Banking, Criminal Investigations, National Compliance, Local Compliance, Special Civil Investigations, Detection, Large Business Service, Valuation Office Agency;

- Product & Process business areas, comprising Pay as You Earn, Self Assessment, Corporation Tax and Value Added Tax, Excise and Stamp Taxes, Benefits and Credits, Charity, Assets & Residence;
- Corporate Functions business areas, comprising Anti-Avoidance, Strategy, Central Compliance, Central Policy, Organisational Development, Commercial, Knowledge Analysis and Intelligence, Communications and Marketing, Information Management Solutions, HR and Learning, Legal and Corporate Governance, Finance and Internal Audit, Estates and Support Services, Security and Business Continuity.

Other Changes Affecting the Department's Responsibilities

The Revenue and Customs Prosecutions Office (RCPO) was created in April 2005 under the Commissioners for Revenue and Customs Act 2005 as a new department operating under the superintendence of the Attorney General. The Director of the RCPO is the Accounting Officer for the new department. The Principal Accounting Officer's responsibilities were transferred across to the Law Officers' Departments.

The RCPO forms an integral part of the UK's Criminal Justice System. It is responsible for prosecuting some of the UK's largest criminal cases involving drug smuggling, money laundering and tax fraud. It is independent from, but works closely with, HMRC.

Comparison Outturn against Estimate

Expenditure outturn for the year was £14,492.4m, £300.8m (2.0 per cent) below the estimate. The variances which exceed 10 per cent are explained below as required by the *Government Financial Reporting Manual*.

- Request for resources 1, e-filing incentives was underspent by £27.8m (11.0 per cent). The volume of employer's returns filed on-line tailed off at the end of the year. The anticipated levels were not reached partly because the campaign to chase outstanding returns was postponed to the end of the financial year.
- Request for resources 4, Payment of Local Authority Rates (POLAR) is underspent by £6.1m (17.2 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 are difficult to forecast with precision.
- Request for resources 5, Child Trust Fund is underspent by £27.6m (11.5 per cent). Initial projections suggested 40 per cent of children would qualify for the supplementary endowment. Analysis of recent trends suggests that this percentage is actually closer to 35 per cent. As a result the Child Trust Fund provision has been reduced by £17.5m.

Managing the Department's Resources

The Department's resources have been managed and controlled in accordance with delegated authority from HM Treasury, and HM Treasury guidance (e.g. *Government Accounting* and the *Government Financial Reporting Manual*). Internal budgetary delegation and expenditure is controlled by a framework of systems and procedures that enable effective decision making and reporting. The resource management system is subject to review as part of the assessment for the "Statement on Internal Control", covering both effectiveness and risk management. This Statement is contained within this document.

The performance of HM Revenue & Customs is assessed through its Public Service Agreement (PSA), Service Delivery Agreement (SDA) and other work targets. Two sets of performance targets apply for 2005-06: those for the period 2003-06 set out in the Spending Review (SR) 2002 for the Inland Revenue and HM Customs and Excise, and those for the period 2005-08 set out in the Spending Review 2004. Full details of performance against those targets are reported in the Board's Annual Report and the Spring and Autumn Performance Reports.

Staff Costs

Staff costs incurred by the Department include wages and salaries, as well as overtime, social security costs, and pension costs. They relate to staff permanently employed by the Department, as well as others engaged on the objectives of the Department.

The Department's staff agreed a three-year pay settlement to provide pay awards for 2005, 2006, and 2007, worth a total of 12 per cent on the 2004 baseline, or 3.86 per cent on average year on year. For staff on the full HMRC terms there are new shorter pay ranges that will reduce the time to reach the range maxima. Pay ranges have been shortened in 2005 and a 'pay assimilation' exercise will take place in 2006. Under this, staff will move to a notional point on the pay range reflecting the number of years of satisfactory or better performance in the grade if their current salary is below this notional point. The 2005 pay award has taken effect from the current settlement dates of 1 June for former HMCE staff, and 1 August for former IR staff, but from 2006 there will be a common settlement date of 1 June. An adjustment will be made for former IR staff in 2005 and 2006 to take account of the earlier settlement date.

Serious Organised Crime Agency

Legislation was passed in April 2005 to allow the creation of the Serious Organised Crime Agency (SOCA) on 1 April 2006. The new agency is responsible for countering the threat from organised crime and reducing the real harms that organised crime causes – for example, the role of organised crime in the supply of Class A drugs.

Staff from the National Crime Squad and the National Criminal Intelligence Service will be joined by staff from the UK Immigration Service and HMRC to form this new organisation. A total of 1,127 HMRC posts, mainly from the Department's Investigation and Intelligence areas with some from Corporate Services, transferred to SOCA from 1 April 2006. Assets currently used in HMRC in pursuit of this work and the associated resource funding will also be transferred for use by SOCA from that date.

Tax Credits IT System

During the year, the Department, Electronic Data Systems Limited (EDS Ltd) and Electronic Data Systems Corporation (EDS Corp) negotiated a settlement claim for compensation for problems experienced with the IT system developed by EDS, to support the 2003 launch and subsequent operation of tax credits, during EDS's partnership with the Inland Revenue.

On 22 November 2005 it was announced that the Department had settled its claim for £71.25m. The settlement included a cash payment of £31m by EDS which has been brought to account in these accounts, and the offsetting of certain amounts (£11.3m for which credit was taken in the 2004-05 accounts, and £2.4m for which credit is taken in these accounts) which would otherwise have been due from HMRC to EDS. The balance of £26.5m will be brought to account in later years' accounts as payment is expected to be made from amounts becoming due to EDS under certain of their future contracts with customers.

Lorry Road User Charge Programme

The Secretary of State for Transport announced in Parliament on 5 July 2005 that plans for distance based lorry charging would be taken forward as part of wider work on national road pricing and that current procurement would not continue. In the particular circumstances of the decision, HM Treasury approved payments of £17.3m to seven contractors who had incurred costs in tendering for services related to the curtailed Lorry Road User Charge (LRUC) procurement. Additionally, a small team from LRUC was seconded to Department for Transport (DfT) to ensure that knowledge gained from the programme could be used in future work on national road pricing. The costs of this team (approximately £0.7m) were met by HMRC for 2005-06.

Child Benefit

Child Benefit is accounted for within programme costs in the Operating Cost Statement (OCS) and includes both Child and Lone Parent benefits. Payments to claimants are recorded as a creditor when the payment falls due. Appropriate accrual and prepayment adjustments are made to ensure that the expenditure arising from the entitlement period of each payment is recorded to the correct month, 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 OCS reduced accordingly. Any overpayment of debt is recovered from future benefit entitlement where possible. Debt deemed irrecoverable is written-off in accordance with the Department's normal remission policy, and recorded as expenditure within the OCS.

Child Trust Fund

The Chancellor of the Exchequer introduced the Child Trust Fund (CTF) in the April 2003 Budget. The CTF is a savings and investment account for children and was available from April 2005 for eligible children born on or after 1 September 2002. A child is eligible for a CTF account if Child Benefit has been awarded to them or they are in care, and they are living in the UK. A total liability at 31 March 2006 of £393.8m (2004-05: £637.4m) has been included within these Resource Accounts, to recognise payments that will become due, in respect of births between 1 September 2002 and 31 March 2006. This has been split as £300.2m (2004-05: £406.7m) as a creditor becoming due in less than one year and £93.6m (2004-05: £230.7m) as a provision for future related costs.

Pensions simplification

This year has seen the culmination of a major project to simplify the pensions tax legislation and its underlying business processes. The new pensions tax regime began on 6 April 2006 (A-Day). The new regime has a single set of rules for tax privileged pension saving. It will improve choice and flexibility for pension providers, employers and individual pension savers, further encourage individuals to save for retirement, and reduce administration and compliance costs for the pensions industry and pension scheme sponsors. The project costs include the development of a new IT system and an allocation of spend of £26m was made for 2005-06. Staff savings will begin to be reaped in 2006-07. The first Pensions Industry consultation document suggested in the partial regulatory impact assessment (RIA) that savings of £80m (or 5 per cent) per annum would be achieved by the Pensions Industry once the simplification changes had been fully introduced.

Direct taxes compliance package

As a result of the Chancellor's 2005 Budget, the Department's expenditure limit was increased by £10m to implement measures announced in that Budget to improve direct tax and NICs compliance.

Partnerships under Private Finance Initiatives

The Department has three 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). 2005-06 was the fifth full year of this twenty-year contract. Costs of some £226.5m were incurred for the provision of serviced accommodation.
- 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. The accounting treatment is explained in note 14.
- Fujitsu contract for Information Systems Infrastructure. 2005-06 was the sixth year of this ten-year contract. Costs of £151.4m were incurred for provision and service of the IS infrastructure and systems development relating to the ex-HMCE infrastructure. This contract came to an end on 31 March 2006.

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 provide 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.

From 1 April 2006, the services previously provided under the Fujitsu contract are now provided through the Capgemini contract.

Public interest and other

Environmental matters

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

HMRC is responsible for administering environmental taxes – e.g. Climate Change Levy, Aggregates Levy and Landfill Tax, and 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 in the protection of endangered species and prevention of 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 also receive their tax credit and other entitlements, also has important positive social and economic impacts.

A key requirement within Securing the Future is the need for departments to firmly integrate sustainable development into policy making, so that we are clear about the impact of all our policies in relation to sustainable development objectives and priorities. The way in which we manage our estate and conduct our business is measured against targets contained in the Framework for Sustainable Development on the Government Estate. Framework targets cover energy and water consumption, waste management, sustainable procurement, travel, biodiversity and social impacts.

Our new Corporate Responsibility Unit will be developing an agenda during the coming year in support of both internal and external issues where we can play a valuable role, such as Business in the Community, Princes Trust, international disaster appeals and the fight against climate change.

Policy on employment of disabled persons

The Department's policy on the employment of disabled persons is included in the Department's general approach to diversity. Diversity is an essential element of how we serve our customers, and recruit and retain our staff. We continue to embed diversity into our business processes by establishing diversity aims and objectives within the Departmental planning process, to demonstrate the links between our business process and diversity actions.

Policy on diversity and equal opportunities

The Department's goal is to become a flagship organisation, leading by example and demonstrating, in measurable ways, that diversity is an integral part of our working life. This means:

- Our services will be accessible and sensitive to different customer needs;
- Our compliance activities and our work at ports and airports will take account of the needs and expectations of small and large businesses and of the individuals with whom we come into contact; and
- Our workforce will reflect the diversity of the communities we serve.

In order to achieve this goal the Department has established a Diversity and Equality Policy. This covers both staff recruitment and career development issues, the recognition of diversity issues affecting both internal and customer-facing policies and processes, the elimination of unjustifiable discrimination, and monitoring and evaluation of progress to ensure compliance with legal obligations.

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).

Provision of information to and consultation with employees

The Department is committed to maintaining good relations with its staff. Consultation with trade unions provides an appropriate focus for this and ensures that staff interests are properly taken into account when decisions are taken. The Department has agreed interim streamlined arrangements for consultation and negotiation with unions during this year. Staff surveys are conducted regularly to obtain staff opinion on many topics related to working within the Department.

The Department makes comprehensive use of an intranet system to provide information concerning all aspects of work and development.

Policy on payment of suppliers

Where there is no contractual provision or other understanding or accepted practice governing the timing of payment, the Department will pay within 30 days of receipt of goods or services or on the presentation of a valid invoice or similar demand for payment, whichever is the later. During 2005-06 98.7 per cent (2004-05: 98.8 per cent) of suppliers were paid within 30 days of registering receipt on the purchasing system.

Interest charges amounting to £93 for 2 invoices (2004-05: £3,168 for 20 invoices) were paid in respect of late payment of commercial debts.

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 Committee 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 with a three month notice period from employee and a five week notice from the employer. No provision for compensation payments or other arrangements has been made in his contract 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 2005-06.

There have been no amounts payable to third parties for services of a senior manager for 2005-06.

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

Remuneration:		2005-06		2004-05
	Salary	Benefits in kind	Salary	Benefits in kind
	£000	(to the nearest £100)	£000	(to the nearest £100)
Sir David Varney	170-175	20,400	85-90 (150-155 full year equivalent)	12,700
Paul Gray CB	155-160	31,900	80-85 (140-145 full year equivalent)	18,400
Dave Hartnett CB	140-145	–	140-145	–
Helen Ghosh (to 31 October 2005)	80-85 (125-130 full year equivalent)	–	110-115 (125-130 full year equivalent)	–
Steve Heminsley	105-110	–	110-115	1,200
Steve Lamey	245-250	9,100	95-100 (200-205 full year equivalent)	4,600
Stephen Jones	110-115	–	20-25 (105-110 full year equivalent)	–
Mike Eland CB	145-150	–	145-150	–
David Hogg CB	135-140	–	60-65 (120-125 full year equivalent)	–
Mike Hanson MBE	125-130	–	125-130	–
Bernadette Kenny (from 23 September 2005)	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.

Ann Chant CB was a Commissioner and member of the Board of Inland Revenue until 18 April 2005, and David Garlick OBE was a Commissioner and member of the Board of HM Customs and Excise until 18 April 2005.

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. Sir David Varney, Paul Gray CB and Steve Lamey had the private use of an allocated car in the circumstances permitted by the Civil Service Management Code.

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:

	2005-06 Salary £000	**2004-05** Salary £000
Bill Griffiths	20-25	5-10 (20-25 full year equivalent)
Mark Haysom (from 1 December 2005)	5-10 (15-20 full year equivalent)	–
Nick Macpherson[1]	–	–
Penny Melville-Brown (from 1 January 2006)	0-5 (15-20 full year equivalent)	–
Kate Owen	20-25	15-20
Barry Quirk CBE	15-20	15-20
John Spence MBE (from 1 September 2005)	10-15 (20-25 full year equivalent)	–
David Spencer	15-20	15-20

[1] *Nick Macpherson is paid by HM Treasury.*

Pension Benefits

	Total accrued pension at age 60 at 31 March 2006 and related lump sum £000	Real increase in pension and related lump sum at age 60 £000	CETV at 31 March 2005 (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 £000)
Sir David Varney[1]	0-5	0-2.5	18	58	33	–
Paul Gray CB[1]	80-85	7.5-10.0	1,198	1,615	158	–
Dave Hartnett CB[3]	50-55 (Plus 130-135 lump sum)	2.5-5.0 (Plus 2.5-5.0 lump sum)	833	1,104	69	–
Helen Ghosh[2] (to 31 October 2005)	30-35 (Plus 100-105 lump sum)	0-2.5 (Plus 5.0-7.5 lump sum)	478	574	29	–
Steve Heminsley[2]	40-45 (Plus 130-135 lump sum)	0-2.5 (Plus 5.0-7.5 lump sum)	722	938	39	–
Steve Lamey[1]	0-5	2.5-5.0	10	53	35	–
Stephen Jones[3]	40-45 (Plus 100-105 lump sum)	2.5-5.0 (Plus 2.5-5.0 lump sum)	551	749	46	–
Mike Eland CB[2]	55-60 (Plus 165-170 lump sum)	0-2.5 (Plus 0-2.5 lump sum)	885	1,116	5	–
David Hogg CB[2]	60-65 (Plus 180-185 lump sum)	2.5-5.0 (Plus 7.5-10.0 lump sum)	1,114	1,392	56	–
Mike Hanson MBE[2]	45-50 (Plus 140-145 lump sum)	2.5-5.0 (Plus 10.0-12.5 lump sum)	803	1,064	77	–
Bernadette Kenny[2] (from 23 September 2005)	30-35 (Plus 90-95 lump sum)	0-2.5 (Plus 0-2.5 lump sum)	414	543	6	–

[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 from a selection of approved products. 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).

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 CS 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.

Please note that the factors used to calculate the CETV were revised on 1 April 2005 on the advice of the Scheme Actuary. The CETV figure for 31 March 2005 has been restated using the new factors so that it is calculated on the same basis as the CETV figure for 31 March 2006.

Real Increase in CETV

This reflects the increase in CETV effectively funded by the employer. It takes account of 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.

Sir David Varney
Principal Accounting Officer
6 July 2006

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:

With effect from 1 April 2005 David Varney was appointed Principal Accounting Officer following his appointment as Executive Chairman of HM Revenue & Customs. At the same time, the following Additional Accounting Officers were appointed:

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.

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 9.

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 2006 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 Cash Flow Statement, the Statement of Operating Costs by Departmental Aim and Objectives, the related notes, and that part of the Remuneration Report that is audited (pages 22 to 24). These financial statements have been prepared under the accounting policies set out within them.

Respective responsibilities of the Accounting Officer and auditor

The Accounting Officer is responsible for preparing the Annual 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 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 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. I also report to you if, in my opinion, the Annual Report is not consistent with the financial statements, 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 pages 1 to 9 reflects the Department's compliance with HM Treasury's guidance on the Statement on Internal Control, and I report if it does not. Solely for the purposes of forming an opinion on the Resource Accounts, I am not required to consider whether the Accounting Officer's statements on internal control cover 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. This other information comprises all of the Annual Report except for the audited part of the Remuneration Report. I consider the implications for my opinion 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.

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 HM Revenue & Customs' affairs as at 31 March 2006 and the net cash requirement, net resource outturn, resources applied to objectives, recognised gains and losses and cash flows 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
- 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.

I have no observations to make on these financial statements.

John Bourn
Comptroller and Auditor General
7 July 2006

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 2005–06

Request for Resources	Note	Estimate Gross Expenditure	Estimate A in A	Estimate Net Total	Outturn Gross Expenditure	Outturn A in A	Outturn Net Total	2005-06 £m Net Total outturn compared with Estimate: saving/ (excess)	Restated* 2004-05 £m Outturn Net Total
RfR 1: Administration	2	5,062.9	(487.5)	4,575.4	4,878.6	(477.5)	4,401.1	174.3	4,094.8
RfR 2: Valuation Office Agency	2	239.3	(239.3)	–	232.8	(232.8)	–	–	–
RfR 3: Payments in lieu of tax relief	2	80.0	–	80.0	78.3	–	78.3	1.7	93.4
RfR 4: Payments of Local Authority Rates	2	39.6	(4.2)	35.4	33.5	(4.2)	29.3	6.1	31.7
RfR 5: Child Benefit and Child Trust Fund	2	10,102.4	–	10,102.4	9,983.7	–	9,983.7	118.7	9,820.6
Total resources	3	**15,524.2**	**(731.0)**	**14,793.2**	**15,206.9**	**(714.5)**	**14,492.4**	**300.8**	**14,040.5**
Non-operating cost A in A				**4.7**			**0.7**	**4.0**	**59.7**

Net cash requirement 2005–06

	Note	Estimate	Outturn	2005-06 £m Net Total outturn compared with Estimate: saving/ (excess)	2004-05 £m Outturn
Net cash requirement	4	**15,531.8**	**14,775.1**	**756.7**	**13,659.4**

** Certain prior year figures have been restated as per note 38.*

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.

	Note	Forecast 2005-06 £m Income	Forecast 2005-06 £m Receipts	Outturn 2005-06 £m Income	Outturn 2005-06 £m Receipts
Total	5	**(338.6)**	***(210.0)***	**(193.3)**	***(212.1)***

The Department is recording and reporting CFER penalties on direct taxes on an accruals basis for the first time in 2005-06.

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

The notes on pages 37 to 73 form part of these accounts.

Operating Cost Statement

for the year ended 31 March 2006

		2005-06 £m						Restated* 2004-05 £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	2,657.5			2,807.0			2,534.6	2,669.9
Exceptional item – building revaluation			–			–		114.7	114.7
Other administration costs	10		1,815.4			1,882.2		1,723.2	1,769.6
Operating income	12			(471.4)			(691.6)	(439.1)	(626.8)
Programme Costs									
Request for resources 5									
Child Benefit and Child Trust Fund:									
Staff costs	9	–			–			–	–
Programme costs	11		9,985.3			9,985.3		9,822.2	9,822.2
Income	12			–			–	–	–
Request for resources 3									
Payments in lieu of tax relief:									
Staff costs	9	–			–			–	–
Programme costs	11		78.3			78.3		93.4	93.4
Income	12			–			–	–	–
Request for resources 4									
Payments of Local Authority Rates:									
Staff costs	9	–			–			–	–
Programme costs	11		–			33.5		–	35.6
Income	12			–			(4.2)	–	(3.9)
Request for resources 1									
Staff costs	9	0.7			0.7			8.0	8.0
Programme costs	11		405.0			405.0		133.4	133.4
Income	12			(6.6)			(6.6)	(9.4)	(9.4)
Totals		**2,658.2**	**12,284.0**	**(478.0)**	**2,807.7**	**12,384.3**	**(702.4)**		
Net Operating Cost	3, 13			**14,464.2**			**14,489.6**	**13,981.0**	**14,006.7**

** Certain prior year figures have been restated as per note 38.*

Statement of Recognised Gains and Losses

for the year ended 31 March 2006

	2005-06 £m		2004-05 £m	
	Core Department	Consolidated	Core Department	Consolidated
Net gain/(loss) on revaluation of tangible fixed assets	70.1	71.0	45.0	45.2
Recognised gains and losses for the financial year	70.1	71.0	45.0	45.2

The notes on pages 37 to 73 form part of these accounts.

Balance Sheet

as at 31 March 2006

									Restated*
					2006				**2005**
					£m				**£m**
	Note		**Core Department**		**Consolidated**		**Core Department**		**Consolidated**
Fixed assets:									
Tangible assets	14		1,196.8		1,224.5		927.4		948.3
Intangible assets	15		11.0		11.0		17.3		17.3
Debtors falling due after more than one year	18		192.5		194.7		213.6		216.0
Current assets:									
Stocks	17	1.2		4.1		1.2		4.0	
Debtors[1]	18	387.5		397.0		412.7		418.9	
Cash at bank and in hand	19	35.3		47.2		78.1		89.4	
		424.0		448.3		492.0		512.3	
Creditors (amounts falling due within one year) [1]	20	(1,145.7)		(1,165.1)		(1,236.7)		(1,254.7)	
Net current liabilities			(721.7)		(716.8)		(744.7)		(742.4)
Total assets less current liabilities			678.6		713.4		413.6		439.2
Creditors (amounts falling due after more than one year)	20		(185.6)		(185.6)		(182.2)		(182.2)
Provisions for liabilities and charges	21		(220.4)		(244.2)		(319.0)		(330.0)
			272.6		**283.6**		**(87.6)**		**(73.0)**
Taxpayers' equity:									
General Fund	22		100.8		109.9		(192.7)		(179.2)
Revaluation Reserve	23		171.8		173.7		105.1		106.2
			272.6		**283.6**		**(87.6)**		**(73.0)**

[1] *The Department is recording and reporting penalties on direct taxes on an accruals basis for the first time in 2005-06. Prior year figures for 'Debtors' and 'Creditors (amounts falling due within one year)' have been restated to include opening balances in respect of these balances.*
** Certain prior year figures have been restated as per note 38.*

Sir David Varney
Principal Accounting Officer
6 July 2006

The notes on pages 37 to 73 form part of these accounts.

Consolidated Cash Flow Statement

for the year ended 31 March 2006

	Note	2005-06 £m	Restated* 2004-05 £m
Net cash outflow from operating activities	24a	(14,391.2)	(13,370.1)
Capital expenditure and financial investment	24b, 24c	(384.3)	(227.2)
Receipts due to the Consolidated Fund which are outside the scope of the Department's activities		207.6	214.1
Payments of amounts due to the Consolidated Fund		(233.7)	(244.1)
Financing from the Consolidated Fund	24d	14,757.8	13,554.3
Financing from the National Insurance Fund	24d	1.6	1.6
Increase/(decrease) in cash in the period	24e	**(42.2)**	**(71.4)**

** Certain prior year figures have been restated as per note 38.*

The notes on pages 37 to 73 form part of these accounts.

Consolidated Statement of Operating Costs by Departmental Aim and Objectives

for the year ended 31 March 2006

			2005-06 £m			Restated* 2004-05 £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	2,818.2	(251.2)	2,567.0	2,580.0	(248.5)	2,331.5
Objective 2	1,723.5	(226.8)	1,496.7	1,618.8	(200.0)	1,418.8
Objective 3	336.9	–	336.9	315.1	–	315.1
RfR 2: Growing a contribution to the good management of property where the public interest is involved.	232.8	(236.7)	(3.9)	198.4	(204.4)	(6.0)
RfR 3: Providing payments in lieu of tax relief to certain bodies.	78.3	–	78.3	93.4	–	93.4
RfR 4: Making payments of rates to Local Authorities on behalf of certain bodies.	33.5	(4.2)	29.3	35.6	(3.9)	31.7
RfR 5: Payments of Child Benefit and Child Trust Fund endowments.	9,985.3	–	9,985.3	9,822.2	–	9,822.2
Intra departmental consolidation adjustment	(16.5)	16.5	–	(16.7)	16.7	–
Net Operating Costs	**15,192.0**	**(702.4)**	**14,489.6**	**14,646.8**	**(640.1)**	**14,006.7**

This statement has been realigned to reflect the Department's three objectives, and therefore it has been necessary to amend prior year figures where relevant. This analysis is approximate, because in practice many activities undertaken by the Department support more than one of the three objectives within RfR 1.

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 38.*
See note 25

The notes on pages 37 to 73 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 2005-06 *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. Expenditure on tangible fixed assets of over £5,000 is capitalised. On initial recognition they are measured at cost including any costs such as installation directly attributable to bringing them into working condition. Appropriate indices are applied to each class of asset shown in note 1.4 for all assets, except intangible fixed assets, which have not been formally valued during the year.

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 assets at 100 Parliament Street and at Elmbridge Court, Gloucester. These assets have been stated at existing use value using professional valuations at least every five years and appropriate indices or interim professional valuations, in intervening 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. With regard to the predecessor Departments, HM Customs and Excise capitalised refurbishments exceeding £50,000 and any projects costing between £50,000 and £150,000 have been expensed during 2005-06; Inland Revenue did not capitalise refurbishment costs and no adjustment has been made for costs expensed prior to April 2005.

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 we will conduct an impairment review of the asset(s) and adjust the value 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	15 to 20 years
Scientific aids	3 to 10 years
Intangible assets (3rd party software licences)	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. Except where reliable evidence of current value cannot be readily ascertained, these are restated to current value each year. 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 purchased uniforms, vessel spare parts and operational equipment.

For reasons of prudence the Department's forms and notices are not valued for stock purposes, as legislative changes could render such forms and notices obsolete. These purchases are accounted for as administration expenditure.

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

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 and other non-departmental public bodies for services provided on a full-cost basis to external customers. It includes not only income appropriated in aid of the Estimate but also income to the Consolidated Fund 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 payments and other disbursements by the Department, as well as certain staff costs where they relate directly to service delivery.

1.9 Cash at Bank and in Hand

These are balances in respect of administering the Department only and 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 and cash balances payable to the Consolidated Fund, where the charge is nil.

1.11 Foreign Exchange

Transactions which are denominated in a foreign currency are translated into sterling at the rate of exchange ruling on the date of each transaction. Translation differences are 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.

Where the risks and rewards have been transferred to the Department via an up-front payment and a call option exists on the asset, the assets are capitalised and depreciated over their useful economic lives.

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 provides 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 debts 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 general provision is made in respect of penalty debtors (note 1.19) to allow for penalties which are expected to be remitted and in respect of Child Benefit debtors to allow for potentially uncollectable amounts. These provisions have been estimated having regard to the level of debts not recovered during 2005-06.

1.18 Value Added Tax

Most of the activities of the Department are outside the scope of VAT and, in general output tax does not apply and input tax on purchases is not recoverable. 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 Penalty Debtors

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.

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 are also 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 and Lone Parent benefits. 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. The liability for future payments for which no payment has been made, are appropriately recognised within creditors amounts falling due within one year and provisions.

1.22 Third Party Assets

The Department holds assets (Euros) on behalf of the European Commission (EC) in relation to the EC's twinning project. These Euros are not recognised in the accounts since neither the Department, nor the Government more generally, has a direct beneficial interest in them.

The Department manages interest bearing accounts containing seized money, and also holds cash and other 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 assets held 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*
								2005-06	**2004-05**
								£m	**£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	4,472.9	178.9	–	4,651.8	(475.9)	4,175.9	4,322.4	146.5	4,094.8
B. e-filing incentive payments	–	–	225.2	225.2	–	225.2	253.0	27.8	–
C. Operational local clearance procedures	–	1.6	–	1.6	(1.6)	–	–	–	–
Total	4,472.9	180.5	225.2	4,878.6	(477.5)	4,401.1	4,575.4	174.3	4,094.8
Request for resources 2:									
A. VOA Administration	232.8	–	–	232.8	(232.8)	–	–	–	–
Request for resources 3:									
A. Payments in lieu of tax relief	–	–	78.3	78.3	–	78.3	80.0	1.7	93.4
Request for resources 4:									
A. Payments of Local Authority Rates	–	33.5	–	33.5	(4.2)	29.3	35.4	6.1	31.7
Request for resources 5:									
A. Children's benefits	–	–	9,771.3	9,771.3	–	9,771.3	9,862.4	91.1	9,593.0
B. Child Trust Fund endowments	–	–	212.4	212.4	–	212.4	240.0	27.6	227.6
Total	–	–	9,983.7	9,983.7	–	9,983.7	10,102.4	118.7	9,820.6
Resource Outturn	**4,705.7**	**214.0**	**10,287.2**	**15,206.9**	**(714.5)**	**14,492.4**	**14,793.2**	**300.8**	**14,040.5**

**Certain prior year figures have been restated as per note 38.*

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

Expenditure outturn for the year was £14,492.4m, £300.8m (2.0 per cent) below the estimate. The variances which exceed 10 per cent are explained below as required by the *Government Financial Reporting Manual.*

- Request for resources 1, e-filing incentives was underspent by £27.8m (11.0 per cent). The volume of employer's returns filed on-line tailed off at the end of the year. The anticipated levels were not reached partly because the campaign to chase outstanding returns was postponed to the end of the financial year.

- Request for resources 4, Payment of Local Authority Rates (POLAR) is underspent by £6.1m (17.2 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 are difficult to forecast with precision.
- Request for resources 5, Child Trust Fund is underspent by £27.6m (11.5 per cent). Initial projections suggested 40 per cent of children would qualify for the supplementary endowment. Analysis of recent trends suggests that this percentage is actually closer to 35 per cent. As a result the Child Trust Fund provision has been reduced by £17.5m.

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

				2005-06 £m	Restated* 2004-05 £m
	Note	**Outturn**	**Supply Estimate**	**Outturn compared with Estimate**	**Outturn**
Net Resource Outturn	2	14,492.4	14,793.2	(300.8)	14,040.5
Non-supply income (CFERs)	5	(4.4)	–	(4.4)	(35.4)
Non-supply expenditure	22	1.6	–	1.6	1.6
Net operating cost		**14,489.6**	**14,793.2**	**(303.6)**	**14,006.7**

3(b) Outturn against final Administration Budget

		2005-06 £m	Restated* 2004-05 £m
	Budget	**Outturn**	**Outturn**
Gross Administration Budget	4,869.8	4,705.8	4,570.8
Income allowable against the Administration Budget	(358.4)	(353.1)	(298.0)
Net outturn against final Administration Budget	**4,511.4**	**4,352.7**	**4,272.8**

**Certain prior year figures have been restated as per note 38.*

4. Reconciliation of resources to cash requirement

	Note	Estimate £m	Outturn £m	Net total outturn compared with estimate: savings/(excess) £m
Resource Outturn	2	14,793.2	14,492.4	300.8
Capital				
Acquisition of fixed assets		378.9	385.0	(6.1)
Investments		–	–	–
Non operating A in A				
Proceeds of fixed asset disposals		(4.7)	(0.7)	(4.0)
Accruals adjustments				
Non-cash items	10, 11	(246.8)	(376.4)	129.6
Changes in working capital other than cash		(36.3)	26.0	(62.3)
Changes in creditors falling due after more than 1 year	20	–	(3.4)	3.4
Use of provisions	21	647.5	252.2	395.3
Excess cash receipts surrenderable to the Consolidated Fund	5	–	–	–
Net cash requirement		**15,531.8**	**14,775.1**	**756.7**

Explanation of the variances between Estimate and cash requirement

- Proceeds of fixed asset disposals varied by £4.0m (85.1 per cent) from the estimate. The sale of Elmbridge Court, Gloucester was not completed during the financial year as expected and there was a reduction in the volume of replacement for other assets during the period.
- Non-cash items varied by £129.6m (52.5 per cent) from the estimate. The cash movement for cost of capital charge was estimated to be £26.0m, the outturn for which was £0.9m. Whilst the Administration cost of capital was £20.0m the effect of negative cost of capital arising from the Programme expenditure £(20.9)m, in particular Child Trust Fund liabilities, was not fully included in the estimate. The cash movement for increase in provisions was estimated to be £36.8m the outturn for which was £166.4m. There were significant additional provisions for Child Trust Fund of £72.0m, and Early Departure Costs of £74.2m were more than expected.
- Changes in working capital other than cash varied by £62.3m (171.6 per cent) from the estimate. A cash requirement of £35.0m was estimated to fund movement in debtors, the outturn required £0.1m. The expected increase in Child Benefit debtors did not materialise, overall the level of debtors remained constant. A negative cash requirement of £(70.9)m was estimated from movement in creditors, the outturn required cash of £30.6m. Child Benefit and Child Trust Fund creditors were reduced by an unexpectedly large amount of £196.1m and whilst other creditors increased by £94.6m the overall affect was to require £101.5m more cash than was estimated.
- Changes in creditors falling due after more than one year varied by £3.4m from the estimate. No separate estimate was made for this item and estimate provision was included in the working capital category.
- Use of provisions varied by £395.3m (61.1 per cent) from the estimate. The estimate was prepared in the expectation that the majority of provisions made for Child Trust Fund expenditure, would be utilised during 2005-06. Provisions totalling £608.2m were made during the financial

years 2003-04 to 2005-06. However, a change in accounting approach caused £287.6m to be transferred to creditors – amounts falling due less than one year, when the 2004-05 Resource Accounts were being prepared in the summer of 2005. This was the major cause of the current variance reported, however in addition a further £88.1m of the provision for Child Trust Fund expenditure was not utilised this year as expected and this remains as a balance to be utilised in future years.

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.

		Forecast 2005-06		Outturn 2005-06	
			£m		£m
	Note	Income	Receipts	Income	Receipts
Operating income and receipts – excess A in A		–	–	(3.9)	*(4.0)*
Other operating income and receipts not classified as A in A		–	–	(0.5)	*(0.5)*
	22	–	–	(4.4)	*(4.5)*
Non-operating income and receipts – excess A in A	7	–	–	–	–
Other non-operating income and receipts not classified as A in A	8	–	–	(12.7)	*(12.7)*
Other amounts collectable on behalf of the Consolidated Fund		(338.6)	*(210.0)*	(176.2)	*(194.9)*
Excess cash surrenderable to Consolidated Fund	4	–	–	–	–
Total income payable to the Consolidated Fund		**(338.6)**	***(210.0)***	**(193.3)**	***(212.1)***

The Department is recording and reporting CFER penalties on direct taxes on an accruals basis for the first time in 2005-06.

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

		2005-06	2004-05
	Note	£m	£m
Operating income	12	(702.4)	(640.1)
Adjustments for transactions between RfRs		(16.5)	(16.7)
Gross income		(718.9)	(656.8)
Income authorised to be appropriated-in-aid		(714.5)	(621.4)
Operating income payable to the Consolidated Fund	5	**(4.4)**	**(35.4)**

7. Non-operating income – Excess A in A

	2005-06	2004-05
	£m	£m
Principal repayments of voted loans	–	–
Proceeds on disposal of fixed assets	–	–
Other	–	–
Non-operating income – excess A in A	–	–

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

	2005-06 Income £m	2005-06 Receipts £m
Single European Authorisation Income	(12.7)	(12.7)

The Department received Single European Authorisation Income (SEA) from Other Member States (OMS) of the EU during the year which was not regarded as income for the Department and was surrendered to the Consolidated Fund. Payments were also made to OMS in respect of their share of Customs Duty collected in the UK.

9. Staff numbers and related costs

Staff costs comprise:

	2005-06 £m			Restated* 2004-05 £m
	Total[1]	Permanently employed staff	Others	Total
Wages and salaries	2,242.8	2,183.2	59.6	2,223.2
Social security costs	165.2	161.7	3.5	159.1
Other pension costs	399.7	390.8	8.9	295.6
Sub-total	**2,807.7**	**2,735.7**	**72.0**	**2,677.9**
Less recoveries in respect of outward secondments	(2.8)	(2.8)	–	(3.4)
Total net costs	**2,804.9**	**2,732.9**	**72.0**	**2,674.5**
Of which:				
Core Department	**2,655.4**	**2,586.8**	**68.6**	**2,539.2**

[1] *Staff consists entirely of officials.*

The Department does not pay the salary of the Minister, Dawn Primarolo MP, 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. HMRC is unable to identify its share of the underlying assets and liabilities. A full actuarial valuation was carried out at 31 March 2003. Details can be found in the resource accounts of the Cabinet Office: Civil Superannuation (www.civilservice-pensions.gov.uk).

For 2005-06, employer's contributions of £399,098,131 were payable to the PCSPS (2004-05: £291,053,172) at one of four rates in the range 16.2 to 24.6 per cent of pensionable pay, based on salary bands (the rates 2004-05 were between 12.0 and 18.5 per cent). The Scheme Actuary reviews employer contributions every four years following a full scheme valuation. From 2006-07, the salary bands will be revised and the rates will be in a range between 17.1 and 25.5 per cent.

The contribution rates are set to meet the cost of the benefits accruing during 2005-06 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 £572,513 (2004-05: £537,600) 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 (2004-05: 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 £42,645, 0.8 per cent (2004-05: £40,887, 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.

239 persons (2004-05: 217 persons) retired early on ill-health grounds; the total additional accrued pension liabilities in the year amounted to £304,564 (2004-05: £304,266).

Average number of persons employed

The average number of whole-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*
			2005-06	2004-05
			Number	Number
	Total	Permanently employed staff	Others	Total
RfR 1: Administration				
Objective 1	51,529	49,177	2,352	55,801
Objective 2	37,484	35,533	1,951	36,883
Objective 3	4,561	4,438	123	4,805
RfR 2: Valuation Office Agency	5,081	4,918	163	4,949
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	1,768	1,679	89	1,688
Total	**100,428**	**95,750**	**4,678**	**104,131**
Of which:				
Core Department	**95,344**	**90,829**	**4,515**	**99,179**

**Certain prior year figures have been restated as per note 38.*

This analysis is approximate, because in practice many activities undertaken by the Department support more than one of the three Objectives within RfR 1.

10. Other Administration Costs

	Note	2005-06 £m Core Department		2005-06 £m Consolidated		Restated* 2004-05 £m Core Department		Restated* 2004-05 £m Consolidated	
Rentals under operating leases:									
Hire of plant and machinery		3.0		3.0		3.7		3.7	
Other operating leases		13.6		14.5		22.0		22.6	
			16.6		17.5		25.7		26.3
Interest charges:									
Finance leases		–		–		–		–	
On-balance sheet PFI contracts		13.2		13.2		3.1		3.1	
			13.2		13.2		3.1		3.1
PFI service charges:									
Off-balance sheet contracts		394.2		408.5		383.8		397.3	
Service element of on-balance sheet contracts		3.8		3.8		1.0		1.0	
Indexation of liability on PFI deals		4.9		4.9		3.0		3.0	
			402.9		417.2		387.8		401.3
Non-cash items:									
Depreciation of fixed assets		134.9		141.2		132.4		140.2	
Amortisation of fixed assets		6.3		6.3		6.1		6.1	
Barter deal prepayments		21.5		21.7		12.2		12.3	
Profit on disposal of fixed assets		–		(0.2)		(0.1)		(0.1)	
Loss on disposal of fixed assets		17.2		17.2		8.5		8.5	
Net (profit)/loss on revaluation		5.6		5.6		20.6		21.2	
Transfer from donated asset reserve		–		–		–		–	
Cost of capital charges		19.5		20.1		21.7		22.3	
Auditors remuneration and expenses[1]		1.9		1.9		0.9		1.0	
Amounts provided for liabilities and charges	21	15.3		18.7		(21.1)		(19.7)	
Amounts provided for early departure costs	21	7.7		21.0		48.7		50.5	
Unwinding of early departure costs discounting	21	1.8		2.4		0.3		0.6	
			231.7		255.9		230.2		242.9

10. Other Administration Costs (continued)

		2005-06 £m		Restated* 2004-05 £m	
	Note	Core Department	Consolidated	Core Department	Consolidated
Other expenditure:					
Travel, subsistence and hospitality		93.7	98.3	89.4	93.5
Accommodation expenses		133.8	143.6	133.6	141.7
Administrative staff related costs		3.6	3.6	5.1	5.1
Printing, postage, stationery and office supplies		124.7	127.3	125.4	128.0
Telephone expenses		19.2	20.9	28.4	30.2
IT services and consumables		499.5	507.2	434.4	442.8
Legal costs		31.3	32.2	27.6	28.0
Consultancy		63.5	65.3	75.5	76.9
Contracted out services		19.2	19.2	16.3	16.3
Publicity		30.3	30.3	24.1	24.1
Post Office services		35.4	35.4	38.1	38.1
Bank charges		17.4	17.4	16.4	16.4
Other miscellaneous expenditure		79.4	77.7	62.1	54.9
		1,151.0	1,178.4	1,076.4	1,096.0
Total		**1,815.4**	**1,882.2**	**1,723.2**	**1,769.6**

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

** Certain prior year figures have been restated as per note 38.*

** The expenditure previously reported in the separate Inland Revenue and HM Customs and Excise accounts for 2004-05 has been reviewed to ensure consistency in reporting for HMRC. This has resulted in a revised presentation of the exceptional item reported in 2004-05.*

11. Programme costs

	Note	2005-06 £m Core Department		2005-06 £m Consolidated		Restated* 2004-05 £m Core Department		Restated* 2004-05 £m Consolidated	
Child Benefit and Child Trust Fund									
Child Benefit		9,763.3		9,763.3		9,575.1		9,575.1	
Child Benefit (Lone Parent) Premium		5.7		5.7		16.5		16.5	
Guardians Allowance (Funded from NIF)		1.6		1.6		1.6		1.6	
Child Trust Fund Endowments		162.7		162.7		126.6		126.6	
			9,933.3		9,933.3		9,719.8		9,719.8
Payments in lieu of tax relief									
Life Assurance Premium Relief, MIRAS, Vocational Training		13.0		13.0		13.0		13.0	
Remitted Stamp Duty		–		–		–		–	
Transitional payments to charities		1.3		1.3		11.7		11.7	
Supplement on payroll giving to charities		–		–		0.7		0.7	
Stakeholder pensions		64.0		64.0		68.0		68.0	
			78.3		78.3		93.4		93.4
Payments of Local Authority Rates									
Payments of Local Authority Rates (POLAR)		–		33.1		–		34.4	
Less programme income		–		(4.2)		–		(3.9)	
			–		28.9		–		30.5
Other Programme Costs									
Incentive Payments		225.2		225.2		–		–	
Legal and investigation		57.2		57.2		54.7		54.7	
Lorry Road User Charge (LRUC)[1]		32.8		32.8		30.7		30.7	
Other programme expenditure		22.4		22.4		31.2		31.2	
Less programme income		(6.6)		(6.6)		(9.4)		(9.4)	
			331.0		331.0		107.2		107.2
Non-cash items									
Provisions	21								
Child Trust Fund provision		72.0		72.0		118.5		118.5	
POLAR provision		–		0.4		–		1.2	
Efficiency Challenge Fund provision		50.9		50.9		–		–	
Other programme provisions		1.0		1.0		10.9		10.9	
Cost of capital charges		(19.1)		(19.1)		(14.5)		(14.5)	
Depreciation of assets		15.3		15.3		11.7		11.7	
Asset write-off		–		–		0.6		0.6	
			120.1		120.5		127.2		128.4
Total			**10,462.7**		**10,492.0**		**10,047.6**		**10,079.3**

[1] *The Secretary of State for Transport announced in Parliament on 5 July 2005 that plans for distance based lorry charging would be taken forward as part of wider work on national road pricing and that current procurement would not continue. In the particular circumstances of the decision, HM Treasury approved payments of £17.3 million to seven contractors who had incurred costs in tendering for services related to the curtailed Lorry Road User Charge (LRUC) procurement. Additionally, a small team from LRUC was seconded to Department for Transport to ensure that knowledge gained from the programme could be used in future work on national road pricing. The costs of this team (approximately £0.7m) were met by HMRC for 2005-06.*

* *The balances previously reported in the separate Inland Revenue and HM Customs and Excise accounts for 2004-05 have been reviewed to ensure consistency in reporting for HMRC. This has resulted in a restatement of the outturn for 2004-05 in this note, increasing the 'programme costs' balance by £2.7m.*

* *Certain prior year figures have been restated as per note 38.*

12. Income

Core Department	RfR 1	RfR 2	RfR 3	RfR 4	RfR 5	2005-06 £m Total	2004-05 £m Total
Income from external customers	(53.8)	–	–	–	–	(53.8)	(35.9)
Income from other departments	(38.5)	–	–	–	–	(38.5)	(66.4)
Income from the National Insurance Fund	(354.5)	–	–	–	–	(354.5)	(345.8)
Other income	(31.2)	–	–	–	–	(31.2)	(0.3)
	(478.0)	**–**	**–**	**–**	**–**	**(478.0)**	**(448.4)**

Consolidated	RfR 1	RfR 2	RfR 3	RfR 4	RfR 5	Total	Total
Income from external customers	(53.9)	(20.0)	–	–	–	(73.9)	(82.8)
Income from other departments	(34.5)	(204.1)	–	–	–	(238.6)	(207.3)
Income from the National Insurance Fund	(354.5)	–	–	–	–	(354.5)	(345.8)
Other income	(31.2)	–	–	(4.2)	–	(35.4)	(4.2)
	(474.1)	**(224.1)**	**–**	**(4.2)**	**–**	**(702.4)**	**(640.1)**

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.

			2005-06 £m			**2004-05 £m**
	Income	**Full Cost**	**Surplus/ (deficit)**	**Income**	**Full Cost**	**Surplus/ (deficit)**
Fees & Charges raised by the Valuation Office Agency (VOA)						
Rating & Council Tax	(204.1)	197.3	6.8	(171.0)	167.3	3.7
Other valuation work	(20.4)	22.7	(2.3)	(19.4)	19.0	0.4
Work on behalf of HMRC	(12.2)	12.8	(0.6)	(12.4)	12.1	0.3
Fees & Charges raised by the Core Department						
International Assistance	(2.4)	2.3	0.1	(1.5)	1.9	(0.4)
Money Service Businesses	(2.2)	2.8	(0.6)	(2.2)	2.5	(0.3)
National Minimum Wage	(5.8)	5.7	0.1	(5.7)	5.7	–
Collection of Student Loans	(3.3)	3.9	(0.6)	(3.5)	3.5	–
DWP Welfare Reform Agenda	(3.0)	3.0	–	(9.3)	9.3	–
DWP Office Services and Accounting	(5.8)	5.6	0.2	(5.6)	5.6	–
Services provided to the Valuation Office	(3.9)	3.9	–	(3.4)	3.4	–
Charges to the National Insurance Fund	(354.5)	360.6	(6.1)	(345.8)	349.2	(3.4)
Total	**(617.6)**	**620.6**	**(3.0)**	**(579.8)**	**579.5**	**0.3**

13. Analysis of net operating cost by spending body

			Restated*
		2005-06	2004-05
		£m	£m
Spending body:	**Estimate**	**Outturn**	**Outturn**
Core Department	14,757.8	14,464.2	13,981.0
Valuation Office Agency	35.4	25.4	25.7
Net Operating Cost	**14,793.2**	**14,489.6**	**14,006.7**

**Certain prior year figures have been restated as per note 38.*

14. Tangible fixed assets

	Freehold Land & Buildings[1]	Accommodation refurbishments	Office & Computer Equipment	Vehicles	Furniture & Fittings[2]	Developed Computer Software	Assets under construction	Vessels	Scientific Aids	Total
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Cost or valuation										
1 April 2005	90.9	147.6	211.7	33.5	122.2	840.9	143.1	28.1	80.4	1,698.4
Adjustments	–	–	–	–	–	–	–	–	–	–
Additions	–	–	60.5	4.2	7.5	10.2	293.8	–	8.3	384.5
Donations	–	–	–	–	–	–	–	–	–	–
Assets completed	–	0.1	1.0	–	–	156.3	(166.4)	–	9.0	–
Disposals	–	(3.0)	(55.4)	(3.9)	(11.2)	(2.5)	–	–	(1.5)	(77.5)
Reclassifications	–	–	(1.0)	–	–	–	–	–	–	(1.0)
Revaluation[3]	4.2	0.8	14.9	2.5	3.2	84.9	–	2.2	0.9	113.6
31 March 2006	**95.1**	**145.5**	**231.7**	**36.3**	**121.7**	**1,089.8**	**270.5**	**30.3**	**97.1**	**2,118.0**
Depreciation										
1 April 2005	(1.1)	(54.1)	(132.6)	(18.9)	(64.1)	(431.7)	–	(6.7)	(40.9)	(750.1)
Adjustments	–	–	–	–	–	–	–	–	–	–
Charged in year	(0.3)	(11.9)	(39.9)	(7.4)	(7.7)	(74.0)	–	(1.9)	(13.4)	(156.5)
Disposals	–	1.9	42.0	3.3	11.2	1.4	–	–	0.9	60.7
Reclassifications	–	–	0.6	–	–	–	–	–	–	0.6
Revaluation[3]	0.2	–	(7.3)	(0.2)	(3.8)	(35.6)	–	(1.1)	(0.4)	(48.2)
31 March 2006	**(1.2)**	**(64.1)**	**(137.2)**	**(23.2)**	**(64.4)**	**(539.9)**	**-**	**(9.7)**	**(53.8)**	**(893.5)**
Net Book Value at 31 March 2006	**93.9**	**81.4**	**94.5**	**13.1**	**57.3**	**549.9**	**270.5**	**20.6**	**43.3**	**1,224.5**
Net Book Value at 31 March 2005	**89.8**	**93.5**	**79.1**	**14.6**	**58.1**	**409.2**	**143.1**	**21.4**	**39.5**	**948.3**
Asset financing:										
Owned	24.9	81.4	94.5	13.1	57.3	549.9	270.5	20.6	43.3	1,155.5
Finance Leased	–	–	–	–	–	–	–	–	–	–
On-balance sheet PFI contracts	69.0	–	–	–	–	–	–	–	–	69.0
PFI residual interests	–	–	–	–	–	–	–	–	–	–
Net Book Value at 31 March 2006	**93.9**	**81.4**	**94.5**	**13.1**	**57.3**	**549.9**	**270.5**	**20.6**	**43.3**	**1,224.5**

Analysis of tangible fixed assets

	Freehold Land & Buildings	Accommodation refurbishments	Office & Computer Equipment	Vehicles	Furniture & Fittings	Developed Computer Software	Assets under construction	Vessels	Scientific Aids	Total
The net book value of tangible fixed assets comprises:										
Core Department at 31 March 2006	93.9	80.6	93.0	13.1	55.0	526.8	270.5	20.6	43.3	1,196.8
Valuation Office Agency at 31 March 2006	–	0.8	1.5	–	2.3	23.1	–	–	–	27.7
Core Department at 31 March 2005	89.8	91.4	77.0	14.6	55.6	395.0	143.1	21.4	39.5	927.4
Valuation Office Agency at 31 March 2005	–	2.1	2.1	–	2.5	14.2	–	–	–	20.9

[1] *See note 1.3.2 for accounting policy for property assets.*
[2] *See note 1.3.3 for accounting policy for furniture.*
[3] *See note 1.3 for the accounting policy regarding revaluation of fixed assets.*

Land and building 100 Parliament Street, on the site formerly known as Government Offices on Great George Street (GOGGS).

The accounting treatment adopted by HM Revenue & Customs (HMRC) in respect of its arrangement with HM Treasury for the land and building on the site, which was formerly known as Government Offices on Great George Street (GOGGS), is consistent with that adopted by HM Treasury.

The contract

The former Departments, the Inland Revenue and HM Customs and Excise, entered into a joint 33-year finance lease agreement with Exchequer Partnership (EP2) in September 2002 in respect of 100 Parliament Street, part of the site formerly known as GOGGS. This agreement provided for the refurbishment and provision of serviced office accommodation to the Departments from November 2004 to October 2037 in return for an annual unitary payment.

The building is subject to a 35-year Private Finance Initiative contract commencing in August 2002 between HM Treasury and EP2. It was in operational use by HM Treasury until vacated in August 2002.

The decision to refurbish GOGGS followed a review by HM Treasury of available alternative locations. EP2 agreed to undertake the risks of planning, construction, ongoing maintenance of the fabric and plant and machinery and the delivery of serviced accommodation to standards originally specified by HM Treasury in advance.

HM Treasury sought to ensure that EP2's bid for refurbishment of the building represented good value for money by detailed evaluation of the technical and financial aspects, benchmarking against the Public Sector Comparator and market rentals at the time. HM Treasury tendered the external project funding to introduce a further element of competition.

Valuation

The Valuation Office Agency (VOA) valued the building and land in November 2005 at £92.6m, an increase of £3.3m over the previous valuation. £2.5m of this relates to the building and is reported as a gain in the Operating Cost Statement given that the reduction in value arising from the previous valuation was greater and was recorded in 2004-05 as an exceptional item of expenditure. 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.

	2005-06 £m	2004-05 £m
Cost or valuation		
1 April	25.0	10.9
Additions	0.5	16.9
Donations	–	–
Disposals	(1.6)	(2.6)
Reclassifications	1.0	(0.2)
Revaluation	–	–
At 31 March	**24.9**	**25.0**
Amortisation		
1 April	(7.7)	(3.7)
Charged in year	(6.3)	(6.1)
Disposals	0.7	2.0
Reclassifications	(0.6)	0.1
Revaluation	–	–
At 31 March	**(13.9)**	**(7.7)**
Net book value at 31 March	**11.0**	**17.3**

Analysis of intangible fixed assets

The net book value of intangible fixed assets comprises:

Core Department at 31 March 2006	11.0
Valuation Office Agency at 31 March 2006	–
Core Department at 31 March 2005	17.3
Valuation Office Agency at 31 March 2005	–

16. Investments

The Department has no financial investments.

17. Stocks and work in progress

		2005-06 £m		2004-05 £m
	Core Department	Consolidated	Core Department	Consolidated
Stocks	0.7	0.7	0.8	0.8
Work in progress	0.5	3.4	0.4	3.2
	1.2	**4.1**	**1.2**	**4.0**

18. Debtors

18(a) Analysis by type

		2005-06 £m		Restated* 2004-05 £m
	Core Department	Consolidated	Core Department	Consolidated
Amounts falling due within one year:				
Trade debtors	0.4	7.7	0.4	6.8
Deposits and advances	24.9	24.8	17.1	15.3
Value added tax	26.8	26.8	19.0	19.0
Other debtors – excluding Child Benefit	23.2	23.8	26.8	27.2
Other debtors – Child Benefit	19.8	19.8	17.3	17.3
Prepayments and accrued income – excluding Child Benefit	24.8	26.3	23.8	24.8
Prepayments and accrued income – Child Benefit	23.4	23.4	34.8	34.8
Barter deals	13.7	13.9	14.8	15.0
Penalties	230.5	230.5	258.7	258.7
Amounts due from the Consolidated Fund in respect of supply	–	–	–	–
	387.5	**397.0**	**412.7**	**418.9**
Amounts falling due after more than one year:				
Trade debtors	–	–	–	–
Deposits and advances	–	–	–	–
Other debtors	0.6	0.6	1.3	1.3
Prepayments and accrued income	–	–	–	–
Barter deals	191.9	194.1	212.3	214.7
	192.5	**194.7**	**213.6**	**216.0**

** Certain prior year figures have been restated as per note 38.*

18(b) Intra-Government Balances

	Amounts falling due within one year		Amounts falling due after more than one year	
		£m		£m
	2005-06	2004-05	2005-06	2004-05
Balances with other central government bodies	53.4	31.9	0.1	–
Balances with local authorities	5.8	2.2	–	–
Balances with NHS Trusts	1.8	1.5	–	–
Balances with public corporations and trading funds	–	0.1	–	–
Subtotal: intra-government balances	61.0	35.7	0.1	–
Balances with bodies external to government	336.0	383.2	194.6	216.0
Total debtors at 31 March	**397.0**	**418.9**	**194.7**	**216.0**

The Department is recording and reporting CFER penalties on direct taxes on an accruals basis for the first time in 2005-06. Income not yet received is reported as a debtor in the balance sheet matched by a corresponding creditor to the Consolidated Fund, (see note 20). Therefore the 2004-05 'Penalties' debtor figure includes an amount of £108m in respect of opening debtor balances for these direct taxes penalties at 1 April 2005.

19. Cash at bank and in hand

		2005-06		2004-05
		£m		£m
	Core Department	Consolidated	Core Department	Consolidated
Balance 1 April	78.1	89.4	155.5	160.8
Net change in cash balances	(42.8)	(42.2)	(77.4)	(71.4)
Balance at 31 March	**35.3**	**47.2**	**78.1**	**89.4**
The following balances at 31 March were held at:				
Office of HM Paymaster General	13.4	25.3	24.6	35.9
Commercial banks and cash in hand	21.9	21.9	53.5	53.5
Balance at 31 March	**35.3**	**47.2**	**78.1**	**89.4**

20. Creditors

20(a) Analysis by type

				Restated*
		2005-06		**2004-05**
		£m		**£m**
	Core Department	**Consolidated**	**Core Department**	**Consolidated**
Amounts falling due within one year:				
Taxation and social security	(49.2)	(49.4)	(43.8)	(44.2)
Trade creditors	(220.1)	(220.4)	(49.8)	(50.7)
Other creditors	(21.7)	(25.3)	(5.0)	(6.6)
Other creditors – Child Benefit and CTF	(306.6)	(306.6)	(480.7)	(480.7)
Accruals and deferred income excluding Child Benefit	(124.4)	(127.8)	(164.5)	(168.3)
Accruals and deferred income – Child Benefit	(172.5)	(172.5)	(179.8)	(179.8)
Finance leases	(1.7)	(1.7)	(1.8)	(1.8)
Current part of imputed finance lease element of on-balance sheet PFI contracts	–	–	–	–
Amounts issued from the Consolidated Fund for supply but not spent at year end	(31.2)	(39.0)	(54.3)	(59.6)
Consolidated Fund extra receipts due to be paid to the Consolidated Fund				
received	(4.1)	(8.2)	(23.8)	(29.8)
receivable	(214.2)	(214.2)	(233.2)	(233.2)
	(1,145.7)	**(1,165.1)**	**(1,236.7)**	**(1,254.7)**
Amounts falling due after more than one year:				
Finance leases	(185.6)	(185.6)	(182.2)	(182.2)
Imputed finance lease element of on-balance sheet PFI contracts	–	–	–	–
	(185.6)	**(185.6)**	**(182.2)**	**(182.2)**

** Certain prior year figures have been restated as per note 38.*

20(b) Intra-Government Balances

	Amounts falling due within one year		Amounts falling due after more than one year	
	£m		£m	
	2005-06	2004-05	2005-06	2004-05
Balances with other central government bodies	(343.4)	(382.4)	–	–
Balances with local authorities	(0.4)	0.2	–	–
Balances with NHS Trusts	(0.1)	–	–	–
Balances with public corporations and trading funds	–	–	–	–
Subtotal: intra-government balances	(343.9)	(382.2)	–	–
Balances with bodies external to government	(821.2)	(872.5)	(185.6)	(182.2)
Total creditors at 31 March	**(1,165.1)**	**(1,254.7)**	**(185.6)**	**(182.2)**

The Department is recording and reporting CFER penalties on direct taxes on an accruals basis for the first time in 2005-06. Income not yet received is reported as a debtor in the balance sheet, (see note 18), matched by a corresponding creditor to the Consolidated Fund. Therefore the 2004-05 'Consolidated Fund Extra Receipts due to be paid to the Consolidated Fund: receivable' includes an amount of £108m in respect of the opening creditor balances at 1 April 2005 in respect of these direct taxes penalties. This debt payable to the Consolidated Fund is proper to be settled once these penalties have been collected by the Department.

21. Provisions for liabilities and charges

	Early Departure Costs	Child Trust Fund	Legal Claims	Accommodation Costs	Other	Total
Core Department	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Balance at 1 April 2005 [1]	(52.7)	(230.7)	(22.6)	(7.4)	(5.6)	(319.0)
Provided in the year	(58.6)	(89.5)	(8.1)	(3.0)	(33.4)	(192.6)
Provisions not required written back	–	17.5	8.0	1.9	18.3	45.7
Provisions utilised in the year	22.8	209.1	7.9	4.0	3.5	247.3
Unwinding of discount	(1.8)	–	–	–	–	(1.8)
Balance at 31 March 2006	**(90.3)**	**(93.6)**	**(14.8)**	**(4.5)**	**(17.2)**	**(220.4)**
Consolidated						
Balance at 1 April 2005 [1]	(59.0)	(230.7)	(24.8)	(7.5)	(8.0)	(330.0)
Provided in the year	(71.9)	(89.5)	(11.3)	(4.3)	(33.7)	(210.7)
Provisions not required written back	–	17.5	9.0	1.9	18.3	46.7
Provisions utilised in the year	25.1	209.1	8.2	4.0	5.8	252.2
Unwinding of discount	(2.4)	–	–	–	–	(2.4)
Balance at 31 March 2006	**(108.2)**	**(93.6)**	**(18.9)**	**(5.9)**	**(17.6)**	**(244.2)**

[1] *Certain prior year figures have been restated as per note 38. The balances previously reported in the separate Inland Revenue and HM Customs and Excise accounts for 2004-05 have been reviewed to ensure consistency in reporting for HMRC. This has resulted in a restatement of the balance at 1 April 2005 reducing the 'legal claims' balance by £3.5m with a compensating increase in the 'other' balance.*

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) establishes tax-free savings and investment accounts for eligible children born on or after 1 September 2002. The Government will make 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. Child Trust Fund accounts have been available to the public from April 2005. A provision of £93.6m has been made for this in the Resource Accounts for the year 2005-06 (2004-05: £230.7m) in respect of amounts that will become due in the period from 1 September 2002 to 31 March 2006. This provision comprises £28.2m in respect of initial endowments that have not yet been issued, £0.5m of endowments for children in Local Authority Care, and £64.9m of supplementary endowments due 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 £18.9m (2004-05: £24.8m (restated)) 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 £5.9m has been made (2004-05: £7.5m) 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 £12.9m (2004-05: £0.0m) have been made in respect of Shipbuilders Relief.
- Provisions relating to various other claims against the Department amount to £4.7m (2004-05: £8.0m).

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.

	Note	2005-06 £m Core Department	2005-06 £m Consolidated	Restated* 2004-05 £m Core Department	Restated* 2004-05 £m Consolidated
Balance at 1 April		(192.7)	(179.2)	200.9	216.3
Prior Period Adjustment		–	–	–	–
Adjusted Opening Balance		(192.7)	(179.2)	200.9	216.3
Net Parliamentary Funding					
Drawn Down		14,727.9	14,754.5	13,549.2	13,583.5
Deemed		54.3	59.6	135.5	135.5
Transferred from Inland Revenue and HM Customs and Excise in respect of transferred RCPO functions	38	–	–	(24.4)	(24.4)
Consolidated Fund Standing Services		–	–	–	–
Net financing from Contingencies Fund		–	–	–	–
National Insurance Fund		1.6	1.6	1.6	1.6
Year end adjustment					
Supply creditor/(debtor) – current year		(31.2)	(39.0)	(54.3)	(59.6)
Excess Vote – prior year		–	–	–	–
Net Transfer from Operating Activities					
Net Operating Cost		(14,464.2)	(14,489.6)	(13,981.0)	(14,006.7)
CFERs repayable to Consolidated Fund		(0.6)	(4.4)	(29.4)	(35.4)
Non-Cash Charges					
Cost of Capital		0.4	1.0	7.1	7.8
Auditors' remuneration		1.9	1.9	0.9	1.0
Transfer from Revaluation Reserve		3.4	3.5	1.2	1.2
Balance at 31 March		**100.8**	**109.9**	**(192.7)**	**(179.2)**

** Certain prior year figures have been restated as per note 38.*

23. Reserves

Revaluation Reserve

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

		2005-06		2004-05
		£m		£m
	Core Department	Consolidated	Core Department	Consolidated
Balance at 1 April	105.1	106.2	61.3	62.2
Arising on revaluation during the year (net)	70.1	71.0	45.0	45.2
Transferred to General Fund in respect of realised element of revaluation reserve	(3.4)	(3.5)	(1.2)	(1.2)
Balance at 31 March	**171.8**	**173.7**	**105.1**	**106.2**

24. Notes to the Consolidated Cash Flow Statement

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

			Restated*
		2005-06	2004-05
	Note	£m	£m
Net operating cost	13	14,489.6	14,006.7
Adjustments for non-cash transactions	10,11	(376.4)	(427.6)
(Increase)/Decrease in Stock	17	0.1	0.3
(Increase)/Decrease in Debtors	18	(43.2)	103.4
less movements in debtors relating to items not passing through the OCS		40.6	(159.8)
Increase/(Decrease) in Creditors	20	86.2	(692.6)
less movements in creditors relating to items not passing through the OCS		(57.9)	226.2
Use of provisions	21	252.2	313.5
Net cash outflow from operating activities		**14,391.2**	**13,370.1**

The Department is recording and reporting CFER penalties on direct taxes on an accruals basis for the first time in 2005-06. Prior year Debtors and Creditors movements have been restated accordingly.

24(b) Analysis of capital expenditure and financial investment

		2005-06	2004-05
	Note	£m	£m
Tangible fixed asset additions	14	384.5	458.0
Intangible fixed asset additions	15	0.5	16.9
Finance lease acquisitions		–	(188.0)
Proceeds of disposal of fixed assets		(0.7)	(59.7)
Loans to other bodies	16	–	–
(Repayments) from other bodies	16	–	–
Net cash outflow from investing activities		**384.3**	**227.2**

** Certain prior year figures have been restated as per note 38.*

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	372.8	–	(0.5)	372.3
RfR 2: Valuation Office Agency	12.2	–	(0.2)	12.0
RfR 3: Payments in lieu of tax relief	–	–	–	–
RfR 4: Payments of Local Authority Rates	–	–	–	–
RfR 5: Child Benefit and Child Trust Fund	–	–	–	–
Total 2005-06	**385.0**	**–**	**(0.7)**	**384.3**
Total 2004-05	**474.9**	**–**	**(59.7)**	**415.2**

24(d) Analysis of financing

	Note	2005-06 £m	Restated* 2004-05 £m
From the Consolidated Fund (Supply) – current year	22	14,754.5	13,583.5
From the Consolidated Fund (Supply) – prior year		–	(0.9)
From the Consolidated Fund (non-Supply)		–	–
From the National Insurance Fund	22	1.6	1.6
Payments to the National Insurance Fund		–	–
Advances from the Contingencies Fund		–	–
Repayments from the Contingencies Fund		–	–
Capital element of payments in respect of finance leases and on-balance sheet PFI contracts		3.3	(3.9)
Transferred from Inland Revenue and HM Customs and Excise in respect of transferred RCPO functions	38	–	(24.4)
Net financing		**14,759.4**	**13,555.9**

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

	Note	2005-06 £m	Restated* 2004-05 £m
Net cash requirement		(14,775.1)	(13,659.4)
From the Consolidated Fund (Supply) – current year	24(d)	14,754.5	13,583.5
From the Consolidated Fund (Supply) – prior year	24(d)	–	(0.9)
Amounts due to the Consolidated Fund received in a prior year and paid over	20(a)	(29.8)	(24.4)
Amounts due to the Consolidated Fund received and not paid	20(a)	8.2	29.8
Increase/(decrease) in cash		**(42.2)**	**(71.4)**

** Certain prior year figures have been restated as per note 38.*

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:	**2005-06**	**Restated 2004-05[1]**
	£m	**£m**
RfR 1: Administration		
Objective 1	360.2	79.7
Objective 2	9.8	16.7
Objective 3	29.0	27.6
RfR 2: Valuation Office Agency	–	–
RfR 3: Payments in lieu of tax relief	78.3	93.4
RfR 4: Payments of Local Authority Rates	29.3	31.7
RfR 5: Child Benefit and Child Trust Fund	9,985.3	9,822.2
Total	**10,491.9**	**10,071.3**

[1] *Certain prior year figures have been restated as per note 38. The expenditure previously reported in the separate Inland Revenue and HM Customs and Excise accounts for 2004-05 has been reviewed to ensure consistency in reporting for HMRC. This has resulted in a restatement of prior year figures to agree with the programme costs as reported in the Operating Cost Statement.*

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 2006

	2005-06	**2004-05**
	£m	**£m**
RfR 1: Administration		
Objective 1	423.4	419.9
Objective 2	353.7	285.4
Objective 3	25.0	40.7
RfR 2: Valuation Office Agency	13.8	18.0
RfR 3: Payments in lieu of tax relief	–	(0.5)
RfR 4: Payments of Local Authority Rates	(2.8)	(3.3)
RfR 5: Child Benefit and Child Trust Fund	(529.5)	(833.2)
Total	**283.6**	**(73.0)**

This analysis is approximate, because in practice many activities undertaken by the Department support more than one of the three objectives within RfR 1.

26. Capital commitments

		2005-06		**2004-05**
		£m		**£m**
	Core Department	**Consolidated**	**Core Department**	**Consolidated**
Contracted capital commitments at 31 March 2006 for which no provision has been made	141.9	142.0	151.1	158.4

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.

		2005-06 £m		2004-05[1] £m
	Core Department	Consolidated	Core Department	Consolidated
Obligations under operating leases comprise:				
Land and buildings:				
Expiry within 1 year	–	1.7	0.3	0.3
Expiry after 1 year but not more than 5 years	–	1.2	–	–
Expiry thereafter	234.0	251.6	230.7	246.5
	234.0	254.5	231.0	246.8
Other:				
Expiry within 1 year	0.7	0.9	0.3	0.4
Expiry after 1 year but not more than 5 years	2.6	2.8	143.2	143.6
Expiry thereafter	482.0	490.9	337.8	347.0
	485.3	**494.6**	**481.3**	**491.0**

27.2 Finance leases

Obligations under finance leases are as follows.

		2005-06 £m		2004-05[1] £m
	Core Department	Consolidated	Core Department	Consolidated
Obligations under finance leases comprise:				
Rentals due within 1 year	19.1	19.1	17.9	17.9
Rentals due after 1 year but within 5 years	81.4	81.4	76.7	76.7
Rentals due thereafter	840.4	840.4	838.2	838.2
	940.9	940.9	932.8	932.8
Less interest element	(562.6)	(562.6)	(559.4)	(559.4)
	378.3	**378.3**	**373.4**	**373.4**

[1] *The balances previously reported in the separate Inland Revenue and HM Customs and Excise accounts for 2004-05 have been reviewed to ensure consistency in reporting for HMRC. This has resulted in a restatement of prior year figures.*

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

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 the Department has a finance lease and that payments comprise two elements – imputed finance lease charges and service charges. Details of the imputed finance lease charges are in the following table.

		2005-06 £m		2004-05[2] £m
	Core Department	Consolidated	Core Department	Consolidated
Imputed finance lease obligations under on-balance sheet PFI contracts comprises:				
Rentals due within 1 year	15.2	15.2	14.3	14.3
Rentals due within 2 to 5 years	64.9	64.9	61.2	61.2
Rentals due thereafter	669.8	669.8	668.0	668.0
	749.9	749.9	743.5	743.5
Less interest element	(562.6)	(562.6)	(559.5)	(559.5)
	187.3	**187.3**	**184.0**	**184.0**

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 £428.6m (2004-05: £406.8m) and the payments to which the Department is committed during 2006-07, analysed by the period during which the commitment expires, is as follows.

		2005-06		2004-05[2]
		£m		£m
	Core Department	Consolidated	Core Department	Consolidated
Expiry within 1 year	–	–	–	–
Expiry within 2 to 5 years	–	–	136.5	136.5
Expiry within 6 to 10 years	11.5	11.5	11.5	11.5
Expiry within 11 to 15 years	203.0	219.2	–	–
Expiry within 16 to 20 years	2.5	2.5	200.3	216.1
Expiry within 21 to 25 years	17.0	17.0	19.0	19.0
Expiry within 26 to 30 years	–	–	–	–
Expiry within 31 to 35 years	3.9	3.9	3.6	3.6

[1] *The estimated capital value is as at commencement of the schemes.*
[2] *The balances previously reported in the separate Inland Revenue and HM Customs and Excise accounts for 2004-05 have been reviewed to ensure consistency in reporting for HMRC. This has resulted in a restatement of prior year figures.*

29. Other financial commitments

The Department has entered into non-cancellable contracts (which are not operating leases or PFI contracts) for various services. The payments to which the Department is committed during 2006-07 analysed by the period which the commitment expires are as follows.

		2005-06		2004-05
		£m		£m
	Core Department	Consolidated	Core Department	Consolidated
Expiry within 1 year	-	-	3.4	3.4
Expiry within 2 to 5 years	11.3	11.3	11.4	11.4
Expiry thereafter	-	-	-	-
	11.3	**11.3**	**14.8**	**14.8**

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 2006 contingent liabilities existed in respect of:

- Shipbuilders' Relief – a contingent liability of £97.9m (2004-05: £106.2m) exists for various claims against the Department.
- Annual Leave Compensation – a contingent liability of £21.0m (2004-05: £21.0m) exists for compensation that may become payable depending on the outcome of a legal case that has been appealed to the House of Lords.
- Legal claims – a contingent liability of £20.2m (2004-05: £12.1m) 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 £4.3m (2004-05: £1.9m).

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 70 (2004-05: 12) indemnities to the value of £0.9m (2004-05: £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

		2005-06		2004-05
	Cases	**£m**	**Cases**	**£m**
Losses are made up of:				
Child Benefit irrecoverable overpayments	*58,332*	10.2	*57,469*	6.6
Law costs remissions	*90,964*	8.3	*70,000*	5.6
Tax penalty remissions[1]	*35,859*	14.0	–	–
Others	*7,160*	8.3	*8,668*	3.0
Total	***192,315***	**40.8**	***136,137***	**15.2**

Details of cases over £250,000

None

33(b) Special Payments

	2005-06		2004-05	
	Cases	**£m**	**Cases**	**£m**
Payments and Accruals	*49,200*	19.1	*55,345*	7.5
New Provisions [2]	*5*	2.2	*8*	5.1
Write back of Provisions	-	(0.5)	-	(2.1)
Total	***49,205***	**20.8**	***55,353***	**10.5**

Details of cases over £250,000

£11.0m – Total of payments made to shortlisted bidders who incurred costs in tendering for services related to the Lorry Road User Charge (LRUC) contract.[3]

£6.3m – Constructive loss following termination of the Lorry Road User Charge programme.[3]

£0.9m – Compensation payment for loss of business due to control and enforcement action.

£0.9m – Ex-gratia payment made as redress for loss incurred as a result of exchange rate fluctuations following a VAT repayment in the incorrect currency.

£0.5m – Compensation payment in respect of a personal injury claim.

£0.4m – Provision for compensation claim relating to an incident in the course of an officer's duties.

£0.3m – Provision for damages claim relating to alleged breach of contract and conspiracy to maliciously prosecute.

£0.3m – Ex-gratia payment made as redress for loss incurred as a result of an incorrect VAT ruling.

[1] Tax penalty remissions have not previously been reported as losses as the former accounting treatment was to set penalty remissions against penalty income, so reporting the net income figure in the Resource Accounts.

[2] The payments previously reported in the separate Inland Revenue and HM Customs and Excise accounts for 2004-05 have been reviewed to ensure consistency in reporting for HMRC. This has resulted in a restatement of the Special Payments 'new provision' in this note for the year ended 31 March 2005. This has the effect of increasing the 2004-05 Special Payments by £3.1m.

[3] The Secretary of State for Transport announced in Parliament on 5 July 2005 that plans for distance based lorry charging would be taken forward as part of wider work on national road pricing and that current procurement would not continue. In the particular circumstances of the decision, HM Treasury approved payments of £17.3m to seven contractors who had incurred costs in tendering for services related to the curtailed Lorry Road User Charge (LRUC) procurement.

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 £99.9m of CFER fines and penalties in 2005-06, 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 the Office of the Deputy Prime Minister (now the Department for 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

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 cash or money due from the sale of seized assets is then due to the Exchequer and is included within "Other amounts collectable on behalf of the Consolidated Fund" (note 5).

35.3 Third-party assets held

These are not Departmental assets and are not included in the accounts. The assets held at the balance sheet date to which it was practical to ascribe monetary values comprised monetary assets, such as bank balances and monies on deposit. They are set out in the following table.

35.3 Third-party assets held (continued)

		31 March 2005	Gross inflows	Gross outflows	31 March 2006
Monies on deposit at the Bank of England					
Euro deposits	€	0.1m	1.4m	(0.8m)	0.7m
Sterling deposits	£	27.2m	20.7m	(29.8m)	18.1m
US Dollar deposits	$	1.4m	0.0m	(0.4m)	1.0m

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

	31 March 2005 Number	31 March 2006 Number
Motor vehicles	1,504	1,257
Vessels	4	3

36. Entities within the departmental boundary

The entities within the boundary during 2005-06 were as follows:

- Supply-financed agencies: Valuation Office Agency
- Non-executive NDPBs: None
- Other entities: None

The Annual Report and Accounts of the Valuation Office Agency are published separately.

37. The creation of HM Revenue & Customs

The new Department, HM Revenue & Customs (HMRC), was formed by the combination of the Inland Revenue (IR) and HM Customs and Excise (HMCE). In this respect, merger accounting principles have been applied in accordance with FRS 6. The effective date of this business combination was 1 April 2005.

No significant accounting adjustments were made to the net assets of any party to achieve consistency of accounting policies.

Analysis of the Operating Cost Statement for the year ended 31 March 2005

	IR £m	HMCE £m	Restatement for transfer of RCPO function £m	HMRC £m
Net administration costs	2,670.0	1,157.2	(14.5)	3,812.7
Administration costs – Exceptional item	61.5	53.2	–	114.7
Net programme costs	9,961.4	134.1	(16.2)	10,079.3
Net operating cost	**12,692.9**	**1,344.5**	**(30.7)**	**14,006.7**

Analysis of the Statement of Recognised Gains and Losses for the year ended 31 March 2005

	IR	HMCE	Restatement for transfer of RCPO function	HMRC
	£m	£m	£m	£m
Total recognised gains and losses for the financial year	**39.1**	**6.3**	**–**	**45.4**

Net Assets as at 31 March 2005

	IR	HMCE	Restatement for transfer of RCPO function	HMRC
	£m	£m	£m	£m
Net Assets	**(242.6)**	**163.3**	**6.3**	**(73.0)**

38. Transfer of function from HM Revenue & Customs

The Revenue and Customs Prosecutions Office (RCPO) was created in April 2005 under the Commissioners for Revenue and Customs Act 2005 as a new Department operating under the superintendence of the Attorney General.

During the year, the staff previously working for the Inland Revenue and HM Customs and Excise were transferred.

The transfer has 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 service 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 function was £30.7m. The share of the balance sheet at 31 March 2005 attributable to the transferred function was £6.3m.

Restatement of Operating Cost Statement at 31 March 2005

	Published accounts at 31 March 2005	Function transferred	Restated at 31 March 2005
	£m	£m	£m
Net administration costs	3,827.2	(14.5)	3,812.7
Administration costs – Exceptional item	114.7	–	114.7
Net programme costs	10,095.5	(16.2)	10,079.3
Net operating cost	**14,037.4**	**(30.7)**	**14,006.7**

Restatement of Balance Sheet at 31 March 2005

Net Assets as at 31 March 2005	**(79.3)**	**6.3**	**(73.0)**

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 105 to 106.

Trust Statement

Contents	Page

Principal Accounting Officer's Foreword to the Trust Statement

Scope

Legislation to create HM Revenue & Customs (HMRC) received Royal Assent on 7 April 2005 and HMRC became a legal entity on 18 April 2005.

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 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
- Tax Credits and
- Recovery of Student Loan repayments

The Trust Statement reports the revenues and expenditures and assets and liabilities related to the taxes and duties for the financial year 2005-06 and reports the full year's activity of HMRC and its predecessors. The costs of running HMRC, and payments of Child Benefit and Child Trust Fund, are reported in the Departmental Resource Accounts.

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 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 £405.2 billion, an increase of £26.0 billion (7 per cent) on last year. This is mainly due to higher revenue from Income Tax, Corporation Tax and National Insurance Contributions (NICs) .

Revenue from Income Tax & NICs accounted for 56 per cent of the total. It was £14.6 billion (7 per cent) higher than in 2004-05 primarily due to increases in earnings.

VAT revenue accounted for 18 per cent of the total. It was £0.4 billion lower than in 2004-05. Revenue has been affected by a combination of factors including weak economic growth and escalating missing trader intra-community fraud. The growth in consumers' expenditure which accounts for around two thirds of the total VAT base has been weak, especially in the sale of consumer durables which attracts the standard rate of VAT.

Revenue for Corporation Tax accounted for 10 per cent of the total. It was £8.4 billion (25 per cent) higher than in 2004-05 mainly due to higher accruals from onshore financial companies and North Sea companies.

Revenue for Hydrocarbon Oils accounted for 6 per cent of the total. It was £0.2 billion (1 per cent) higher than in 2004-05.

The remaining taxes accounted for 10 per cent of the total and increased by £3.2 billion (8 per cent) on last year.

Total Revenue losses reduced by £228 million (6 per cent). This was due to a reduction of £952 million in remissions offset by a £724 million increase in write-offs. In 2004-05 remissions had been unusually high due to one large liability of £1,200 million, relating to alcohol duties, remitted under my approval.

Write-offs increased mainly due to a £633 million (76 per cent) increase in VAT write-off due to a successful drive to write-off uncollectable debt quicker, in response to National Audit Office recommendations.

Provision for Doubtful Debt increased by £1.0 billion (24 per cent).

In Spring 2006, HMRC completed its testing of 2003-04 tax credits awards, based on a sample of some 4500 random enquiries against claimant records. As a result of this, HMRC estimates that claimant error and fraud accounted for incorrect payments in claimants favour of between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value of finalised entitlement) and incorrect payments in HMRC's favour of between £0.19 billion and £0.28 billion (1.6 to 2.3 per cent by value of finalised entitlement) of awards made for 2003-04.

HMRC takes very seriously its obligation to identify the elements of the tax credits system that could lead to error and fraud, and to address these once they had been identified. HMRC will continue to tackle error and fraud vigorously and will work to:

- further understand the characteristics of their customers and what influences their behaviour, including the impact of HMRC processes and activities on that behaviour;
- support and encourage customers to claim their rightful entitlement and ensure that HMRC's administration of the system supports this;
- identify error and fraud and take the appropriate action including, in the most serious cases of deliberate fraud, investigating with a view to securing a criminal prosecution; and
- support compliance by continuing to make good use of the information held by HMRC, and better use of data held by other Government departments and third parties.

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).

This is the first Trust Statement produced by HMRC, and is prepared on an accruals basis. This is consistent with the work performed by the former HM Customs and Excise and Inland Revenue. For the first time last year they prepared their Trust Statements on an accruals basis, which changed the emphasis from reporting the net cash received in a given year to the revenue earned in respect of that year.

The comparatives are therefore derived from the consolidation of the Trust Statements reported by HM Customs and Excise and the Inland Revenue.

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 four 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 2004-05 Inland Revenue 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 sub-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 income from self-employment is assumed to rise by 4.4 per cent in 2005-06.

Indirect taxes and duties are significantly different in nature so that significant estimation techniques are not required to the same extent. There is an element of estimation in respect of the accrued revenue information but the only material element is VAT.

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.

Sir David Varney
Principal Accounting Officer
6 July 2006

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 2005-06. In conforming with HM Treasury direction (see pages 105 to 106 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 and 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 9.

The Certificate and Report 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 2006 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. I also report to you if, in my opinion, the Foreword is not consistent with the financial statements, 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 pages 1 to 9 reflects the Department's compliance with HM Treasury's guidance on the Statement on Internal Control, 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 statements on internal control cover 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 Foreword 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 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 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.

Qualified opinion arising because the Trust Statement includes tax credit payments that have not been applied to the purposes intended by Parliament

As shown in Note 3.4 to the Trust Statement, Her Majesty's Revenue and Customs estimates that for 2003-04 claimant error and fraud accounted for incorrect payments in claimants favour of between £1.06 billion and £1.28 billion (8.8 per cent to 10.6 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 2003-04. There is no evidence to justify a lower estimate for claimant error and fraud for 2005-06. 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 Trust Statement in this respect.

In my opinion:

- the financial statements give 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 2006 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 financial statements have 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; and
- except for the probable level of error leading to significant amounts of tax credits being paid to claimants to which they are not entitled 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.

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

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 of £75.9 billion and accrued revenue liabilities of £24.9 billion at 31 March 2006. As described in Note 6.1.4, the Department considers that the combined accrued revenue receivable and accrued revenue liabilities at 31 March 2006 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 and my opinion is not qualified in respect of this matter.

Please see my report at pages 84 to 86 on these matters.

JOHN BOURN
Comptroller and Auditor General
7 July 2006

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

HM Revenue and Customs 2005-06 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 2005-06 the Department collected some £314.1 billion in tax revenues, against total expenditure of £16.1 billion. It also collected other revenue of £91.1 billion, principally £90.9 billion of national insurance contributions. Disbursements totalling £91.1 billion, primarily comprised £90.5 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 £16.0 billion of expenditure on tax credits awards in 2005-06. In accordance with 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 2005-06 tax credit expenditure comprised £4.1 billion classified as negative taxation and £11.9 billion classified as payments of entitlement.

Qualified opinion arising because the Trust Statement includes tax credit payments that have not been applied to the purposes intended by Parliament

My responsibilities with regard to regularity

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. I am also required 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. 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.

The legal framework

5. 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

6. As stated in Note 3.4, HMRC establishes its overall measure of the level of claimant error and fraud by investigating a random sample of tax credit awards. Under the Tax Credits Act 2002, it cannot commence its investigation into randomly selected awards until the awards have been finalised. While most awards for 2003-04 were finalised by the end of September 2004, some could not be finalised until the end of January 2005 if taxpayers submitted an initial estimate of their circumstances for the period of the award. The Department could not therefore start its investigation of some of the final awards for 2003-04 until February 2005.
7. In Spring 2006, HMRC completed its testing of 2003-04 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 £1.06 billion and £1.28 billion (8.8 per cent to 10.6 per cent of the final award by value) being paid to claimants to which they were not entitled.
8. HMRC currently has no estimate of the overall level of claimant fraud and error in the tax credit awards for 2004-05 and 2005-06. As certain tax credit awards for 2004-05 would only have been finalised in February 2006, the Department is in the process of investigating a random sample of awards for that year. Tax credit awards for 2005-06 are not due to be finalised until January 2007. There is, however, no evidence to justify a lower estimate for claimant error and fraud for 2005-06, compared to 2003-04.
9. 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 the regularity part of my opinion on the Department's Trust Statement for 2005-06 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

10. 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.
11. The Trust Statement records accrued tax revenue receivable of £75.9 billion at 31 March 2006, 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.
12. The Trust Statement also records some £24.9 billion in respect of accrued revenue liabilities at 31 March 2006, 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.
13. 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.

14. 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, which does not significantly affect the reported position. This figure is equivalent to less than one per cent of total Revenue reported in the Statement of Revenue and Expenditure.

15. 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 2006.

16. 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

17. 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 2006 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
7 July 2006

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

Statement of Revenue and Expenditure for the year ended 31 March 2006

	Notes	2005-06 £ billion	2004-05 £ billion
Taxes and Duties			
Income Tax		134.8	130.9
Value Added Tax	2.1	73.8	74.2
Corporation Tax	2.2	41.4	33.0
Hydrocarbon Oils Duties		23.5	23.3
Alcohol Duties		7.9	9.1
Stamp Taxes	2.3	11.1	9.0
Tobacco Duties		8.4	8.1
Other Taxes and Duties	2.4	17.3	14.9
Tax Credits treated as Negative Taxation	3.1	(4.1)	(3.7)
Total Taxes and Duties		**314.1**	298.8
Other Revenue			
National Insurance Contributions	4.1	90.9	80.2
Student Loan Recoveries	4.3	0.2	0.2
Total Other Revenue		**91.1**	80.4
Total Revenue		**405.2**	379.2
Less Expenditure			
Tax Credits treated as Payments of Entitlement	3.1	(11.9)	(10.1)
Bad and Doubtful Debts	8.1	(4.3)	(4.1)
Provision for Liabilities	9	0.1	(0.1)
Total Expenditure		**(16.1)**	(14.3)
Less Disbursements			
National Insurance Contributions due to the National Insurance Funds and National Health Services	4.1	(90.5)	(79.8)
Student Loan Recoveries due to the Department for Education and Skills	4.3	(0.2)	(0.2)
Taxation Revenue due to the Isle of Man	5	(0.4)	(0.2)
Total Disbursements		**(91.1)**	(80.2)
Total Expenditure and Disbursements		**(107.2)**	(94.5)
Net Revenue for the Consolidated Fund		**298.0**	284.7

The notes at pages 90 to 104 form part of this Statement.

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

Balance Sheet as at 31 March 2006

	Notes	31 March 2006 £ billion	Restated 31 March 2005 £ billion
Debtors falling due after more than one year	6	**2.5**	1.9
Current Assets			
Debtors	6	14.3	13.5
Accrued Revenue Receivable	6	75.9	70.5
Cash at Bank and in Hand		–	0.2
		90.2	84.2
Current Liabilities			
Creditors	7	13.8	12.0
Accrued Revenue Liabilities	7	24.9	18.7
Deferred Revenue	7	0.5	0.3
		39.2	31.0
Net Current Assets		**51.0**	53.2
Total Assets less Current Liabilities		**53.5**	55.1
Provision for Liabilities	9	**–**	(0.1)
Total Net Assets		**53.5**	55.0
Represented by:			
Balance on Consolidated Fund Account	10	**53.5**	55.0

The notes at pages 90 to 104 form part of this Statement.

The Balance Sheet was approved by the Principal Accounting Officer.

Sir David Varney
Principal Accounting Officer
6 July 2006

Cash Flow Statement for the year ended 31 March 2006

	Notes	2005-06 £ billion	2004-05 £ billion
Net Cash Flow from Revenue Activities	A	299.3	280.2
Cash paid to Consolidated Fund		(299.5)	(279.9)
(Decrease)/Increase in Cash in this period	B	**(0.2)**	0.3

Notes to the Cash Flow Statement

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

	2005-06 £ billion	2004-05 £ billion
Net revenue for the Consolidated Fund	298.0	284.7
Increase in Non-cash Assets	(6.8)	(5.2)
Increase in Liabilities	8.2	0.6
(Decrease)/Increase in Provision for Liabilities	(0.1)	0.1
Net Cash Flow from Revenue Activities	**299.3**	280.2

B: Analysis Of Changes In Net Funds

	2005-06 £ billion	2004-05 £ billion
(Decrease)/Increase in Cash in this period	(0.2)	0.3
Net Funds as at 1 April (Opening Cash at Bank)	0.2	(0.1)
Net Funds as at 31 March (Closing Cash at Bank)	**0.0**	0.2

The notes at pages 90 to 104 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, tax 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.

This is the first Trust Statement produced by HMRC. Comparative figures have been obtained from the published Inland Revenue and HM Customs and Excise Trust Statements for 2004-05.

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 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. Amounts outstanding at the balance sheet date are recognised as creditors. 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.

1.6 Capital Gains Tax (CGT) – Change in Accounting Policy

In the 2004-05 Trust Statement CGT was accounted for on a cash basis. HMRC are now in a position to measure CGT debtors reliably. The debtor position at 31 March 2005 has been restated to include £0.4 billion of CGT debt. There is no effect of the CGT revenue for 2004-05. The effect on CGT revenue in 2005-06 is an increase of £0.1 billion on the equivalent cash position.

2 Taxes and Duties Due

2.1 Value Added Tax

	2005-06 £ billion	**2004-05** £ billion
Gross VAT receipts	134.4	125.3
Less: Repayments	(60.6)	(51.1)
Net VAT receipts	**73.8**	74.2

2.2 Corporation Tax

The Corporation Tax revenue of £41.4 billion (2004-05: £33 billion) is net of Land Remediation Relief, and Research and Development Tax Credits. The estimated figures for the payable elements of these credits are £5 million (2004-05: £5 million) for Land Remediation Relief and £225 million (2004-05: £225 million) for Research and Development.

2.3 Stamp Taxes

	2005-06 £ billion	**2004-05** £ billion
Stamp Duty Land Tax	7.7	6.3
Stamp Duty Reserve Tax	2.9	2.3
Stamp Duty	0.5	0.4
	11.1	9.0

2.4 Other Taxes and Duties

	Note	2005-06 £ billion	2004-05 £ billion
Inheritance Tax		3.3	3.0
Capital Gains Tax		3.2	2.3
Insurance Premium Tax		2.4	2.3
Petroleum Revenue Tax		2.0	1.4
Customs Duties		1.9	1.5
Betting And Gaming Duties		1.4	1.4
Air Passenger Duty		0.9	0.9
Landfill Tax	2.5	0.8	0.7
Climate Change Levy		0.7	0.7
Agricultural Duties		0.4	0.4
Aggregates Levy		0.3	0.3
Total Revenue Due		**17.3**	14.9

2.5 Landfill Tax

The Landfill Tax revenue of £756 million (2004-05: £673 million) is that receivable after a reduction of £45.6 million (2004-05: £43.9 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:

	Negative Tax 2005-06 £ billion	Payments of Entitlement 2005-06 £ billion	Net Expenditure 2005-06 £ billion	Net Expenditure 2004-05 £ billion
Child Tax Credit	2.7	7.9	10.6	10.0
Working Tax Credit	1.4	4.0	5.4	3.8
Total Tax Credits	**4.1**	**11.9**	**16.0**	13.8

In 2005-06 £1,260 million (2004-05: £1,648 million) was paid via employer to recipients of Working Tax Credit. Tax credit payments via employers have been withdrawn from the 2006-07 tax year. 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 Reconciliation between Net Expenditure and payments of Tax Credits:

	Note	2005-06 £ billion	2004-05 £ billion
Tax Credits Net Expenditure		16.0	13.8
Remissions and Write-offs	8.2	0.4	0.1
Increase in Debtors	6	1.0	1.8
(Increase)/Decrease in Creditors		(0.1)	0.1
Payments Made		**17.3**	15.8

Tax credit overpayments identified through in-year change of claimant circumstances or through the year end finalisation exercise may be recovered in two ways: offset against future tax credit payments; or through repayments made by claimants, known as direct recoveries. Payments made are net of offset recoveries. During 2005-06 £125 million was directly repaid by claimants – the movement in debtors for 2005-06 includes the effect of this receipt.

3.3 Tax Credit Debtors

	Note	2005-06 £ billion	2004-05 £ billion
Debtors as at 1 April	6	2.6	0.9
2003-04 Finalisation Overpayments		–	1.3
2004-05 Finalisation Overpayments		0.9	–
Overpayments identified from change of circumstances in year		1.0	0.9
Other terminated payments		0.1	–
Recoveries made		(0.6)	(0.4)
Remissions/Write-offs	8.2	(0.4)	(0.1)
Debtors as at 31 March	6	**3.6**	2.6
Provision for doubtful debts		(1.4)	(1.0)
Net		**2.2**	1.6

Further overpayments relating to tax credits paid in 2003-04 totalling £32 million were identified during 2005-06. In addition, overpayments relating to tax credits paid in 2004-05 totalling £854 million were identified during 2005-06 as a result of the finalisation exercise undertaken in 2005-06. These have been accounted for in 2005-06.

The recoveries made to date consist of £0.8 billion of offset recoveries by the computer system and £0.2 billion direct recoveries made. Of the offset recoveries, £0.7 billion related to 2003-04 overpayments and £0.1 billion related to 2004-05 overpayments

In accordance with the accounting policy for tax credits (Note 1.3), amounts under or over paid in 2005-06 that are identified during the finalisation exercise undertaken in 2006-07 are not included in the above figures. The values of under and over payments arising from the 2005-06 finalisation exercise are estimated to be in the same order as those from the 2004-05 exercise.

Remissions and write-offs in 2005-06 include £131 million written-off in respect of fraudulent claims identified during the year.

3.4 Tax Credits Fraud and Error

HMRC establishes its final measure of the level of error and fraud by investigating a random sample of awards. Under the Tax Credit Act 2002, HMRC cannot commence its investigation into randomly selected awards until they have been finalised. While most awards for 2003-04 were finalised by the end of September 2004, some could not be finalised until the end of January 2005 if taxpayers submitted an initial estimate. The Department could not therefore start its investigation of some cases until February 2005.

In Spring 2006, HMRC completed its testing of 2003-04 awards, based on a sample of some 4500 random enquiries against claimant records. As a result of this, HMRC estimates that claimant error and fraud accounted for incorrect payments in claimants favour of between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value of finalised entitlement) and incorrect payments in HMRC's favour of between £0.19 billion and £0.28 billion (1.6 to 2.3 per cent by value of finalised entitlement) of awards made for 2003-04.

3.5 The Cost of Managing and Paying Tax Credits

The cost of managing and paying Working Tax Credit was £159 million (2004-05: £133 million) and Child Tax Credit £308 million (2004-05: £342 million). The total cost of £467 million (2004-05: £475 million) has been charged to the Resource Accounts.

4 Other Revenue

4.1 National Insurance Contributions

	Note	Net Revenue 2005-06 £ billion	Net Revenue 2004-05 £ billion
Revenue		90.9	80.2
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		**90.5**	79.8

	Net Revenue 2005-06 £ billion	Cash Paid to NIFs/NHS 2005-06 £ billion	Net Movement 2005-06 £ billion	Net Movement 2004-05 £ billion
National Insurance Fund – Great Britain	(71.5)	68.5	(3.0)	(1.2)
National Insurance Fund – Northern Ireland	(1.3)	1.3	–	(0.1)
National Health Services	(17.7)	16.9	(0.8)	(0.1)
Totals	**(90.5)**	**86.7**	**(3.8)**	(1.4)

The National Insurance Fund cash balances as at 31 March 2006 were:

- Great Britain: £299.7 million (opening balance at 1 April 2005: £284.0 million)
- Northern Ireland: (£81.7 million) (opening balance at 1 April 2005: (£18.5 million)).

The combined balance of £218 million is included within creditors (Note 7).

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 receipts 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 2005-06 £ million	CTD Redemptions 2005-06 £ million	CTD Total 2005-06 £ million	CTD Total 2004-05 £ million
Receipts	112	157	269	293
Payments	(111)	(153)	(264)	(297)
	1	4	5	(4)
Balance at 1 April			(4)	–
Balance at 31 March (Included in creditors/(debtors))			**1**	(4)

4.3 Student Loan Recoveries

	2005-06 £ million	2004-05 £ million
Receipts	181	209
Payments	(170)	(253)
Balance	11	(44)
Balance at 1 April	(14)	30
Balance at 31 March (Included in debtors)	**(3)**	(14)

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 overpayment of £3 million to the DfES at 31st March 2006 which, with HM Treasury authorisation, will be rectified by reducing payments to DfES during 2006-07. 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 2005-06 £ million	Net Revenue 2004-05 £ million
Cash Payments	346	202
Add opening debtors	1	26
Add closing creditors/(less closing debtors)	22	(1)
Total Taxation Revenue due to Isle of Man	**369**	227

6 Debtors and Accrued Revenue Receivable

	Debtors as at 31 March 2006 £ billion	Accrued Revenue Receivable as at 31 March 2006 £ billion	Total as at 31 March 2006 £ billion	Restated Total as at 31 March 2005 £ billion
Debtors and Accrued Revenue Receivable due within one year:				
Income Tax	6.3	23.8	30.1	30.8
Value Added Tax	5.5	20.6	26.1	24.0
Corporation Tax	1.2	13.4	14.6	13.8
Hydrocarbon Oils Duties	0.1	1.1	1.2	1.2
Alcohol Duties	0.4	0.5	0.9	0.9
Stamp Taxes	–	0.9	0.9	0.7
Tobacco Duties	0.1	1.6	1.7	1.3
Other Taxes and Duties	0.9	1.7	2.6	2.4
Tax Credit Overpayments	0.9	–	0.9	0.8
National Insurance Contributions	3.1	12.3	15.4	11.7
Totals before Provision	18.5	75.9	94.4	87.6
Less Provision	(4.2)	–	(4.2)	(3.6)
	14.3	**75.9**	**90.2**	84.0
Debtors due after more than one year:				
Inheritance Tax	0.7	–	0.7	0.6
Tax Credit Overpayments	2.7	–	2.7	1.8
Totals before Provision	3.4	–	3.4	2.4
Less Provision	(0.9)	–	(0.9)	(0.5)
	2.5	**–**	**2.5**	1.9
Totals before Provision	**21.9**	**75.9**	**97.8**	90.0
Less Provision (Note 8.4)	(5.1)	–	(5.1)	(4.1)
Total	**16.8**	**75.9**	**92.7**	85.9

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 and 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 companies is paid by four quarterly instalment payments (QIPs). Accrued revenue receivable has been estimated where between one and four QIPs 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:

	2005-06 (per cent)	**2004-05 (per cent)**
Proportion of Corporation Tax liability remitted with first QIP	26.7	29.5
Proportion of Corporation Tax liability remitted with second QIP	26.7	28.4
Proportion of Corporation Tax liability remitted with third QIP	26.7	26.1
Adjustment for overpayment of Corporation Tax liabilities	(9.3)	(9.3)
Adjustment for late payment of Corporation Tax liabilities	4.5	4.0

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 2006 Financial Statement & Budget Report. The growth rates used for 2004-05 and 2005-06 are shown below:

	2005-06 (per cent)	**2004-05 (per cent)**
Annual growth in Corporation Tax liabilities	14.7	14.6

6.1.2 Self Assessment Income Tax and National Insurance Contributions Class 4

Accrued revenue receivable represents accrued liabilities for 2005-06 where payment is not yet due at 31 March 2006. The estimation process has three stages:

(i) estimation of accrued liabilities for 2005-06. The estimates used are those prepared for Budget 2006 on the basis of the economic assumptions provided by HM Treasury. The most important of these is that self-employment income is assumed to have risen by 4.4 per cent in 2005-06 (2004-05: 4.4 per cent);

(ii) deduction from the 2005-06 accrued liabilities of relevant payments by 31 March 2006. 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 four 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 2006	Accrued Revenue Liabilities as at 31 March 2006	Deferred Revenue as at 31 March 2006	Total as at 31 March 2006	Total as at 31 March 2005
	£ billion	£ billion	£ billion	£ billion	£ billion
Value Added Tax	2.6	9.5	–	12.1	9.0
Corporation Tax	10.7	–	0.2	10.9	9.5
National Insurance Funds and the NHS	0.2	15.4	–	15.6	12.0
Other Revenue Creditors	0.2	–	0.3	0.5	0.4
Sundry Creditors	0.1	–	–	0.1	0.1
Total	**13.8**	**24.9**	**0.5**	**39.2**	31.0

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

		2005-06	2004-05
		£ billion	£ billion
Revenue Losses	8.2	(3.3)	(3.6)
Increase in Provision for Doubtful Debts	8.4	(1.0)	(0.5)
Total Bad and Doubtful Debts		**(4.3)**	(4.1)

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 2005-06 £ million	Write-offs 2005-06 £ million	Total 2005-06 £ million	Remissions 2004-05 £ million	Write-offs 2004-05 £ million	Total 2004-05 £ million
Income Tax	53	509	562	45	531	576
Value Added Tax	18	1,468	1,486	23	835	858
Corporation Tax	3	235	238	3	319	322
Alcohol Duties	1	42	43	1,198	1	1,199
Tobacco Duties	–	75	75	–	7	7
National Insurance Contributions	13	445	458	10	442	452
Tax Credits	349	48	397	119	4	123
Other Remissions and Write-offs	11	47	58	2	6	8
Total Revenue Losses	**448**	**2,869**	**3,317**	1,400	2,145	3,545

Remissions are debts capable of recovery but HMRC has decided not to pursue the liability, on the grounds of value for money. Write-offs are debts written-off because there is no practical or economical means for pursuing the liability. New revenue losses terminology has been developed to ensure that there is consistency within HMRC.

The split between remissions and write-offs for some direct tax revenue losses is not available on a financial year basis. Where information is not available the split has been calculated using averages across two previous years. A review is underway to ensure consistency of reporting and align the reporting of direct tax losses information with the end of the financial year. The Department's intention is that this will be finalised in time for the production of the 2006-07 Trust Statement.

National Insurance Contribution write-offs include £63 million (2004-05: £67 million) of Class 2 contributions no longer collectable as they became time barred in year.

8.3 Revenue Losses – Cases over £10 million

There was a write-off of £166 million (VAT Excise and Customs Duty) related to a cigarette diversion fraud perpetrated from 1995 to 1997. Following a criminal investigation by the Department, two defendants were acquitted and a third received a prison sentence and a £100,000 confiscation order.

There was a write-off involving Missing Trader Intra Community Fraud (MTIC) for £89 million VAT. Large quantities of mobile phones were acquired from suspect or missing EC traders. Criminal proceedings are being considered but the suspect is currently serving a prison sentence related to other offences. Further losses are expected to be reported as a result of this case in the next financial year.

There were seventeen write-offs relating to VAT insolvency over £10 million each – totalling £282 million, and one write-off relating to Corporation Tax insolvency for £15 million.

8.4 Provision for Doubtful Debts

	2005-06 £ billion	2004-05 £ billion
Balance as at 1 April	4.1	3.6
Balance as at 31 March	5.1	4.1
Increase in Provision for Doubtful Debts	**(1.0)**	(0.5)

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 2005-06 £ million	Legal Claims 2004-05 £ million
Balance at 1 April	(82)	–
Provided in the year	(18)	(82)
Provision not required written back	24	–
Provision utilised in the year	42	–
Balance at 31 March	**(34)**	(82)

A provision has been made for legal claims against HMRC relating to Indirect Taxes, where it is probable that there will be a material amount of revenue repaid to traders. Legal claims, which may succeed but are less likely to do so, or cannot be measured reliably, are disclosed as contingent liabilities in Note 11.

10 Balance on Consolidated Fund Account

	2005-06 £ billion	Restated 2004-05 £ billion
Balance on Consolidated Fund Account as at 1 April as previously stated	55.0	49.8
Prior period adjustment (see Note 1.6)	–	0.4
Balance on Consolidated Fund Account as at 1 April as restated	55.0	50.2
Net Revenue for the Consolidated Fund	298.0	284.7
Less amount paid to Consolidated Fund	(299.5)	(279.9)
Balance on Consolidated Fund Account as at 31 March	**53.5**	55.0

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 and for some cases it is not practicable to estimate the financial effect.

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.

HMRC considers that it is not meaningful to disclose the financial impact of cases where liability to taxes or duties is subject to legal challenge, because of the high degree of uncertainty in both the outcome of litigation and the timing of any potential outflow.

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.

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 2006 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 2006 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 2006 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 as set out in the letter to Finance Directors dated 17 January 2006 (MS FD (06) 01).

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 separate Directions for the Resource Accounts and Trust Statements issued to HM Customs and Excise on 22 July 2005 and to the Board of Inland Revenue on 25 July 2005.

IAN CARRUTHERS FCA CPFA
Director, Government Reporting, HM Treasury
7 February 2006

National Audit Office

HM REVENUE & CUSTOMS 2005-06 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 2005-06 Accounts of HM Revenue & Customs

John Bourn
Comptroller and Auditor General
7 July 2006

EXECUTIVE 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 2005-06 provided overall assurance that HM Revenue & Customs regulations and procedure continued to provide an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That overall assurance is subject to reservations about the operation of tax credits. The report also includes observations on the collection of income tax through PAYE and the measures taken by HMRC to tackle Value Added Tax missing trader fraud.

Creation of HM Revenue & Customs

3 In March 2004, the Chancellor of the Exchequer announced the creation of a new Department to bring together the functions of HM Customs and Excise and the Inland Revenue, and the transfer of some tax policy work to HM Treasury. HMRC was established in April 2005[1] and brought together in one entity most of the functions of the Inland Revenue and HM Customs and Excise. HMRC has established a high level governance structure. It has also continued to develop its risk management arrangements, building on what it inherited from the Inland Revenue and HM Customs and Excise.

4 HMRC is taking forward the compliance strategies of the Inland Revenue and HM Customs and Excise, which were focused around specific tax streams. It has also begun work on producing a comprehensive and unified approach across the whole of HMRC's activities. HMRC has developed a spectrum of compliance activities, designed to inform its approach to different types of compliant and non-compliant taxpayers, which is focused on making it easier for taxpayers to get it right first time and targeting its compliance effort on those who present the greatest threat of non-compliance.

1 The Commissioners for Revenue and Customs Act 2005.

Tax credits

5 The tax credits system was changed in April 2003 and in 2005-06 HMRC paid a net £17.3 billion to tax credit claimants and an average of 5.3 million families received provisional 2005-06 awards. HMRC uses the latest information it holds on claimants to calculate a provisional tax credit award and make payments. It makes a final assessment after the end of the year when the claimant's actual circumstances are known. The final award is often higher or lower than the provisional award, for example because the final income differs from the provisional income.

6 HMRC estimates that it overpaid £1.8 billion and underpaid £556 million in tax credits in 2004-05 and that the position for 2005-06 awards will be similar. When HMRC identifies an underpayment it pays the claimant a lump sum and it seeks to recover overpayments from future awards or, if there is no ongoing entitlement, directly from the claimant. The recovery of overpayments has caused hardship to some families and HMRC has struggled to manage disputes about recovery. It cannot recover all overpayments and in 2005-06 wrote off £397 million and made a provision of £409 million for doubtful debts.

7 The December 2005 Pre-Budget Report announced changes to the tax credits system which were designed to provide greater certainty to claimants, particularly when families see a rise in income. One important change will be to raise from £2,500 to £25,000 for 2006-07 awards the threshold for increases in income which will be disregarded when provisional awards are re-assessed. There will also be new responsibilities on claimants to tell HMRC promptly about changes in their circumstances. The Treasury has been unable to provide reliable costings for the individual elements of the package. The success of these measures in reducing overpayments and recoveries will become apparent only in 2008 following finalisation of 2006-07 awards.

8 HMRC estimated that in 2003-04 claimant error and fraud resulted in tax credits of between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value) being paid to claimants to which they were not entitled. It also estimates that claimant error resulted in between £190 million and £280 million (1.6 to 2.3 per cent by value) of tax credits not being paid to claimants when they were entitled to them. These are the first full results for the scheme since it was introduced in April 2003. These levels are unacceptably high and there is currently no evidence to justify a lower estimate for 2005-06. Consequently, I have qualified my opinion on the Trust Statement. Now HMRC has a baseline figure, it needs to target future reductions in levels of error and fraud.

9 HMRC tries to maintain a balance between accessibility of the tax credits 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 it checks these before or after claims are paid. In 2005-06, HMRC completed compliance checks and other actions against 195,000 claims, identifying incorrect payments made of £250 million and preventing incorrect payments of £447 million. HMRC prioritises its compliance activity on the claims it considers represent the highest risk. High risk claims that are not fully examined before payment are picked up for subsequent checking. HMRC has set a target for this compliance work which is based on the number of checks. It needs to consider how these can be developed into outcome based targets, such as reductions in fraud to provide better information on the effectiveness of its compliance work.

10 In 2005 there was a serious attack on the tax credits system by organised criminals submitting false claims using stolen identities. HMRC identified incorrect payments of around £131 million in 2005-06. Its Organised Fraud Strategy Board is overseeing investigations into 41 separate organised tax credit fraud cases, most of which involve multiple claims using stolen identities. HMRC cannot yet give a precise figure for the overall sums involved, but its initial indications are that the total losses on these cases were £26 million. HMRC is conducting further work to establish firmer estimates to support the case for prosecution.

11 HMRC closed the tax credits e-portal on 2 December 2005 as a consequence of these attacks and it accepts that additional controls need to be built into the e-portal before it can be re-opened. HMRC needs to ensure that the new system fully complies with established government standards on security. HMRC has reviewed the other channels through which tax credits can be claimed and has introduced new measures to safeguard against fraud. It needs to continue to assess the wider implications of the fraud and how organised criminals might respond to the closure of the tax credits e-portal.

The collection of income tax through PAYE

12 In 2005-06 HMRC collected £114 billion income tax through PAYE from some 41 million employment and pension sources operated by 1.9 million employer or pension schemes. HMRC 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.

13 The PAYE computer system was introduced in the 1980s and its records are structured around employments, rather than individual taxpayers. As a result, HMRC can have difficulty in ensuring that taxpayers with more than one source of income pay the correct amount of tax because it may not know about additional sources of income.

14 To operate PAYE effectively, HMRC depends on employers and employees providing it with accurate and timely information on income and changes in employment. This does not always happen and can lead to the risk that taxpayers do not pay the right amount of tax. For example, HMRC estimates that for about 70 per cent of job changes employees do not immediately provide their new employer with the form P45, giving details of previous earnings and tax. And employers do not always update tax codes despite being instructed to do so.

15 The difficulties in the operation of PAYE have been compounded by inconsistent working practices within HMRC. Staff have not always been aware of or followed Departmental policies, for example adjusting tax codes to reflect Benefits in Kind. Deficiencies in management information have also made it difficult for HMRC to prevent or detect errors made by staff. And several times in recent years HMRC has diverted PAYE resources to other areas of work which it considered had higher operational priority, such as tax credits.

16 Over the last eighteen months HMRC has produced new information to provide a better picture of the scale of these problems and the amount of tax at stake. Based on a sampling exercise, its Internal Audit Office estimates that each year HMRC may not be pursuing some £1 billion of tax due, taxpayers may have overpaid around £500 million and consequently that 5.7 million taxpayers may not be paying the right amount of tax. These figures suggest an overall net under collection of tax revenue of some 0.5 per cent of the £114 billion collected through PAYE in 2005-06.

17 HMRC has responded by reminding staff of the importance of following procedures, improving its internal quality monitoring procedures and has introduced a programme to deliver a better experience for the taxpayer. It has also allocated additional resources to PAYE work. Whilst it believes these changes should reduce the level of errors, it recognises that real improvement requires fundamental changes. Accordingly, HMRC plans to improve its internal processes as part of its 'Modernisation of PAYE Processes for Customers (MPPC)' project. This project should also provide a complete view of an employee's tax affairs by making better use of the information HMRC already holds. Successful implementation should reduce a major source of error but HMRC considers the computer changes cannot be achieved before 2008 because of the technical challenges. HMRC has developed a series of responses to manage the risks in the interim period, but it needs to articulate these more clearly into an overall strategy.

18 Effective operation of PAYE also depends on employers and employees meeting their obligations and changing internal processes and systems will not address all the problems. HMRC needs to target and take further action to improve compliance by employers and employees who do not meet their obligations.

19 HMRC first recognised the emerging difficulties in administering PAYE in 2001-02, when it launched a recovery programme to clear the increasing number of open cases. But it has only recently begun to quantify the effect of these difficulties on the collection of tax. This quantification, coupled with HMRC's new organisational structure, has provided additional impetus to tackle these difficulties through a programme of short, medium and longer term improvements. In taking forward these improvements, and as new systems are developed, HMRC must ensure that it has appropriate management information to monitor the effectiveness of its procedures in collecting tax. Within its new framework for managing PAYE, HMRC also needs to have appropriate arrangements for monitoring emerging trends in the labour market to allow it to develop an appropriately planned response to future changes in the taxpayer population.

VAT: Missing Trader Fraud

20 Missing trader fraud is one of the most serious attacks on the tax system ever seen. It is a systematic attack by organised criminal groups on the European Union VAT system. HMRC's strategy, launched in September 2000, reduced the losses: in 2003-04 the level of fraud fell for the second year running, to between £1.06 billion and £1.73 billion. However, 2004-05 saw an increase in losses of between £1.12 billion and £1.9 billion and the latest operational indicators suggest that the level of activity related to the fraud has increased. The organised criminals behind the fraud are very resourceful and have reacted quickly to measures implemented by HMRC, setting up sophisticated and contrived transaction chains to avoid detection. To address these latest developments, HMRC has further strengthened its operational activities and plans to introduce new legal measures to help tackle the fraud.

21 Tax practitioners recommended the introduction of a reverse charge mechanism to the tackle the fraud in evidence to the House of Lords Economic Affairs Committee in 2003. This measure would remove the VAT from the distribution chain from wholesaler to retailer, and thus reduce the possibility of this type of fraud occurring. Other measures introduced in 2003 have proved successful in reducing the level of fraud. However, in 2005 the confidence of the fraudsters and the level of fraud increased. The Government sought a derogation in December 2005 from the European Commission to permit the introduction of a reverse charge for goods normally associated with the fraud, such as mobile phones and computer chips. HMRC has estimated that, if approved, this measure will yield an additional £1 billion of VAT receipts over the next three years. There is, however, a risk that the fraudsters will divert to goods not covered by the legislation.

22 HMRC and other Member States, supported by the Commission, are working closely through administrative cooperation to tackle the fraud. However, fraudsters can obtain goods free of VAT and continue to perpetrate this type of fraud whilst the current arrangements in the VAT system remain. The Commission has considered an overhaul of the current VAT system, but due to a lack of consensus, Member States have not agreed a definitive system. HMRC should continue to lead work with the European Commission and other Member States to highlight the difficulties in tackling the fraud within the current legislative framework and to identify long term mechanisms through which tax authorities across the European Union may tackle the fraud.

23 Within the current VAT framework, improvements could be made to the quality and timeliness of information shared between Member States. Through the introduction of scanning databases in the UK and other Member States, there will also be opportunities to share greater detailed information to identify consignments of goods and traders involved in fraudulent chains. This information will therefore help HMRC to target its resources to tackle the fraud. The UK and some other Member States are now experiencing missing trader fraud that transcends the external borders of the European Union into third countries. The Commission has recently stated that it would like to see a community approach to cooperation with third countries. HMRC should use its experience and influence to facilitate these arrangements.

24 Several of the large accountancy firms and professional bodies have publicly supported HMRC's approach to tackle the fraud and sought to develop guidance for their clients and members who may come into contact with missing traders. HMRC should continue to work closely with these organisations to identify further measures that could be successfully introduced in the UK. Many of these organisations are also established or have affiliates across the European Union, and counterparts in these offices may have useful suggestions in tackling the fraud.

Statement on Internal Control

25 HMRC 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 Statement on Internal Control for 2005-06 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) and VAT Missing Trader Fraud (Part four). Some of the other control matters in the Statement on Internal Control are discussed below.

Delivering Efficiency Savings

26 The 2004 Spending Review required HMRC to achieve by 1 April 2008 net staff reductions of 12,500 full time posts, the redeployment of 3,500 posts to front-line roles and annual efficiency savings of £507 million. HMRC reported to the Office of Government Commerce (OGC) that by 1 April 2006 it had reduced staff numbers by a net 4,322 full time equivalents and had made savings of £105 million. Additionally, HMRC has made over 2,600 re-deployments to front line activities, which together represented a gross reduction of some 7,000 full time posts.

27 In December 2005 OGC raised concerns about potential gaps that had opened up in HMRC's plans for delivering headcount reductions and apparent gaps in detailed planning for efficiency following restructuring of the Department. HMRC and OGC subsequently carried out a joint priority review, which concluded with a series of agreed recommendations to improve the management of the Efficiency Programme. In line with the joint report's recommendation, HMRC's Executive Committee agreed to strengthen the Efficiency Programme Board's terms of reference to give it greater authority.

National Insurance Debt

28 Class 2 National Insurance is a flat rate contribution (currently £2.10 per week) paid by the self-employed. When HMRC is notified that a person is self-employed, it assumes they will continue to be liable for these contributions until it is told otherwise. Inevitably, therefore some of the debt balances held on the HMRC systems will not be amounts genuinely owed – for example, where a person has ceased self-employment, but has failed to notify HMRC. In my report for 2004-05, I noted that HMRC's systems recorded £616 million outstanding National Insurance debt at the end of 2004-05 which was over six years old and therefore time barred. HMRC concluded that of the £616 million recorded, £283 million was not actual debt and it also wrote off the balance of £333 million as time barred. HMRC sought to take urgent action to prevent further debts becoming time barred at 31 March 2006. But limitations in its computer system have hampered its ability to identify debt about to become time barred. HMRC has developed a strategy to ensure it manages these debts much more quickly in the future.

Tax repayments

29 In my 2004-05 Standard Report on the Inland Revenue I noted that a lack of formalised accountabilities had made it difficult for the Department to establish central oversight and responsibility, including the extent to which agreed controls over repayments were being operated. It also made it difficult to establish the degree to which these controls could prevent or detect error and irregularities. In response, the Finance Director has set up and chairs a Departmental Steering Group to establish central control and direction of HMRC's strategy on repayments and repayments security.

30 In the spring of 2006 Internal Audit reported that there were continuing weaknesses in HMRC's controls over tax repayments. On the basis of a sample of Self Assessment and Pay As You Earn (PAYE) repayments, Internal Audit estimated that taxpayers had potentially been overpaid £203 million and underpaid £45 million as a result of these weaknesses. In addition, they reported that underlying papers could not be found for 16 per cent of the sample of PAYE repayments. To strengthen operational controls, HMRC has issued guidance to staff reminding them of the importance of following the correct processes and retaining supporting papers. The Finance Director's Steering Group has a responsibility to ensure that this guidance is followed.

PART ONE

SCOPE OF THE AUDIT AND SIGNIFICANT DEVELOPMENTS

Introduction

1.1 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.

Audit approach

1.2 In examining the extent to which HM Revenue & Customs has established adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue and whether HMRC is properly 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 HMRC's operations and tax streams, including:
  - HMRC's response to the challenges of delivering Tax Credits effectively, which I have covered in Part 2 of this Report;
  - HMRC's management of Pay as You Earn, which I have dealt with in Part 3 of this Report; and
  - HMRC's response to managing VAT Missing Trader Fraud, which I have reported on in Part 4 of this Report.
- 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:
  - How the Department's area offices manage the Corporation Tax of small to medium sized businesses; (HC 678: 2005-06)
  - How HMRC deal with VAT on e-commerce; (HC 1051: 2005-06)
- Examined the governance arrangements for the new Department, including risk management and Information Systems governance. As part of this work, my staff have also considered the Department's Statement on Internal Control (paragraphs 1.14 to 1.25 below) that provides a source of assurance about the quality of HMRC's internal control framework.
- Followed up on previous developments in areas that I covered in my Standard Report on the 2004-05 Trust Statement and Resource Accounts of the Inland Revenue and HM Customs & Excise.
- 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 2005-06 Trust Statement (84 to 86).

Conclusion

1.3 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 2005-06 provided overall assurance that HM Revenue & Customs regulations and procedure continued to provide an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That overall assurance is subject to reservations about the operation of tax credits. The report also includes observations on the collection of income tax through PAYE and the measures taken by HMRC to tackle Value Added Tax missing trader fraud.

Creation of HM Revenue & Customs

1.4 In March 2004, the Chancellor of the Exchequer announced the creation of a new Department to bring together the functions of HM Customs and Excise and the Inland Revenue, and the transfer of some tax policy work to HM Treasury. HMRC was established in April 2005[2] and brought together in one entity most of the functions of the Inland Revenue and HM Customs and Excise. Not all of the functions provided by the Inland Revenue and HM Customs and Excise transferred to the new Department. In April 2004, 150 full time posts responsible for providing advice to Ministers on aspects of tax policy transferred to HM Treasury. At 1 April 2005, 223 posts transferred to the Revenue and Customs Prosecutions Office, a newly created government department operating under the superintendence of the Attorney General. Finally, in April 2006, under legislation passed on 1 April 2005, 1,127 full time equivalent staff engaged in investigation and intelligence work on serious drug trafficking and related criminal finance transferred to the new Serious Organised Crime Agency[3].

New governance arrangements

1.5 To manage the new organisation, HMRC has established a high level governance structure; the main features of which are:

- **A Departmental Board** which comprises the Commissioners for HM Revenue & Customs, plus the other members of the Executive Committee, the Chief Executive of the Valuation Office Agency and HMRC's Non-Executive Directors. Its role is to set the Department's strategic direction and to provide advice to the Executive Committee.
- **An Executive Committee** which is the primary decision making forum for HMRC. Its members' responsibilities cover the whole of the core Department.
- **An Operating Committee** which supports the Executive Committee by providing oversight of HMRC's day to day performance.
- **An Audit Committee** which comprises non-executive board members and advises the Chairman in his responsibilities for risk management, internal control and corporate governance.

1.6 The underlying structure of HMRC contains thirty six business units each of which is headed by a Director. These units are grouped into four business streams.

- **Operations**, which is responsible for delivering high quality, cost effective services. The core activities are delivering customer contact, processing and operational compliance; delivering enforcement capabilities; and debt management and banking;
- **Product and Process Groups**, which focus on taxes, duties, credits and benefits and the processes by which they are delivered;
- **Customer Units**, which focus on identifying and understanding the requirements and behaviours of its customers and the associated risks; and
- **Corporate Functions** such as Human Resources and Finance.

In addition to these business units, HMRC has established a number of cross-cutting operational working groups to help it deliver its aims and objectives. These include, for example, working groups that have oversight of HMRC's delivery against each of its Public Service Agreement (PSA) targets, as well as groups with a tax focus that help develop HMRC's strategy for compliance on particular tax streams.

Risk management

1.7 The governance structures I have described above provide the framework within which HMRC has continued to develop its risk management arrangements, building on what it inherited from the Inland Revenue and HM Customs and Excise. The HMRC Executive Committee is responsible for shaping the Department's risk management arrangements, determining the risk priorities and reviewing progress in managing HMRC's strategic risks. It is supported by a Risk Management Group, which is a peer-review group of risk owners who challenge the effectiveness of HMRC's actions in managing its top risks and identify new risks.

2 The Commissioners for Revenue and Customs Act 2005.

3 The Serious Organised Crime Agency was created in April 2006 under the Serious Organised Crime and Police Act 2005. It brought together the National Crime Squad, National Criminal Investigation Service, the Immigration Service's work on organised crime, and HMRC's investigation and intelligence work on serious drug trafficking and related criminal finances.

1.8 In 2005-06 HMRC introduced important new elements to its risk management framework. These included a mechanism to ensure the upward reporting of risks in the Directors' regular reporting on performance. The Directors are held to account by the Chairman and Executive Committee members for their performance on a quarterly basis. Each Director provides a commentary on performance against plans and the likely year end position. This process helps inform HMRC's Chairman and Executive Committee of major and immediate risks and the current response to these risks. Executive Committee members also hold monthly meetings with Directors to discuss strategic issues facing the Department. HMRC is aware that it needs to do further work to continue to embed risk management into the management of business performance.

Compliance

1.9 Integration allows the new Department to focus on compliance activities across all tax streams. Whilst HMRC is taking forward the compliance strategies of the Inland Revenue and HM Customs and Excise, which were focused around specific tax streams, work has also begun on producing a comprehensive and unified approach across the whole of HMRC's activities. HMRC has developed a spectrum of compliance activities, designed to inform its approach to different types of compliant and non-compliant taxpayers, which is focused on making it easier for taxpayers to get it right first time and targeting its compliance effort on those who present the greatest threat of non-compliance.

1.10 HMRC has started a programme of work to modernise its approach to taxpayer compliance by looking at both the quality of service it delivers to taxpayers and the effectiveness of its compliance activities. It has also begun to look at compliance from customer and behavioural perspectives. This involves identifying underlying causes of non-compliance (for example, owing to complexity of processes) and seeking to design these out wherever possible. Important strands in HMRC's programme involve:

- **implementing its anti-avoidance agenda** to know what avoidance schemes are marketed and used, to identify those individuals and organisations predisposed to avoidance, to deploy HMRC's investigation and litigation resources on the basis of that knowledge, and to improve its ability to combat avoidance through more effective 'avoidance proofing' of tax legislation;
- **developing relationships with tax advisers** to make better use of the contribution they can make in developing a more effective tax administration system and closer working with representative bodies and firms both to improve tax advisers' performance and to encourage them to stress the importance of ethical conduct;
- **developing front line compliance** by improving risk assessment, providing better information to support enquiries and investigations, redesigning the inquiry process to make it more effective, and developing a more effective framework of investigations; and
- **creating a central compliance team** to provide a focus for developing a more co-ordinated approach to compliance across HMRC, to quality assure the plans of all units engaged in compliance work, and to co-ordinate its work in delivering its Public Service Agreement targets for compliance.

Information Systems

1.11 Efficient and effective information systems are essential to the administration of taxes and integration offers the opportunity of improving the service that the information systems provide. HMRC currently spends over £1 billion each year on its Information Systems related activities, with over 250 major computer systems supporting the full range of HMRC's work.

1.12 Both the Inland Revenue and HM Customs and Excise had built large computer systems, but many of these systems now need strengthening and updating. These systems were primarily created in reaction to the need to provide new work, such as Tax Credits or online services. In 2005 HMRC prepared a new Strategic Framework for IT which is designed to enable it to pro-actively use IT to improve the way it provides services. In the future, HMRC is looking to:

- enhance the links between IT development and its internal business areas to enable their needs to be identified;
- improve how it prioritises IT development work; and
- work closely with its IT supplier to review areas where services can be improved.

Review of HMRC powers

1.13 The creation of HMRC 'ring-fenced' the powers of each former Department and carried them forward into HMRC. But during the passage of the Commissioners for Revenue and Customs Bill, the Government announced a major review of the powers of HMRC. This aims to design a coherent framework of law and practice for HMRC to support the Government's objectives of a tax system that is fair and better adapted to the needs of customers. In June 2005, the Government established a Consultative Committee to provide advice on future powers, deterrents and safeguards that should underpin the tax system. This Committee includes representatives of the tax credits community, businesses, employees and the tax-related professions. In March 2006, HMRC issued a consultation document setting out its thinking following the early consultation on the requirements of a modern tax administration. As well as taking on board the results of this consultation, the review team plan to look at further areas of HMRC's powers throughout 2006-07.

Statement on Internal Control

1.14 To meet his reporting responsibilities to Parliament, the Principal Accounting Officer has provided in pages 1 to 9 of the 2005-06 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 5.3 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 6.30 of the Statement.

1.15 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 HMRC'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.

1.16 HMRC 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 Finance Director 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 of the Executive Committee. HMRC's Internal Audit has developed a robust process for scrutinising the Statement on Internal Control, including analysis of the underlying material, that is independent of the Executive Committee's own review procedures. HMRC's Audit Committee also examines and challenges the Statement on Internal Control, drawing on both the Finance Director's own review process as well as Internal Audit's work.

1.17 The Statement on Internal Control for 2005-06 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) and VAT missing trader fraud (part four). Some of the other control matters in the Statement on Internal Control are discussed below.

Delivering Efficiency Savings

1.18 The 2004 Spending Review required HMRC to achieve by 1 April 2008 net staff reductions of 12,500 full time posts, the redeployment of 3,500 posts to front-line roles and annual efficiency savings of £507 million. The Department's objective was to deliver the majority of these savings in 2006-07 and 2007-08, by putting in place plans involving:

- investment in Information and Communication Technology;
- reform of back office functions;
- savings in procurement of goods and services;
- improvements in productive time; and
- re-engineering of business processes.

As part of the governance arrangements HMRC's Executive Committee established an Efficiency Programme Board to help oversee and steer delivery of the efficiency and business change programme.

1.19 HMRC reported to the Office of Government Commerce (OGC) that by 1 April 2006 it had reduced staff numbers by a net 4,322 full time equivalents and had made savings of £105 million. Additionally, HMRC has made over 2,600 re-deployments to front line activities, which together represented a gross reduction of some 7,000 full time posts. The Department has faced some IT capacity problems which have affected progress in delivering the savings and it has revised its plans to identify non IT solutions needed to delivery the efficiency savings.

1.20 In December 2005 OGC raised concerns about potential gaps that had opened up in HMRC's plans for delivering headcount reductions and apparent gaps in detailed planning for efficiency following restructuring of the Department. HMRC and OGC subsequently carried out a joint priority review, which concluded with a series of agreed recommendations to improve the management of the Efficiency Programme. In line with the joint report's recommendation, HMRC's Executive Committee agreed to strengthen the Efficiency Programme Board's terms of reference to give it greater authority to provide:

- improved governance and accountability arrangements to hold others to account in relation to the delivery of change;
- better and more regular reporting of progress to the Executive Committee;
- more active risk management procedures and monitoring of the effect of failure or delays in the underlying programmes; and
- clear sign up by Directors to Delivery Plans and commitments to efficiency targets for 2006-07 and 2007-08.

Under the revised control arrangements, the membership of the Efficiency Programme Board has changed to include Directors who are responsible for the delivery of the significant efficiency targets. The Board membership is also aligned with the responsibilities the Executive Committee has allocated for implementing the various change portfolios.

1.21 Following changes made as part of HMRC's 2006-07 business and resource planning process, the Efficiency Programme Board monitors the progress of the principal programmes that are aimed at delivering the efficiency savings set out in the 2004 spending review. HMRC has reshaped its change portfolio to focus on what is needed to deliver its April 2008 PSA and efficiency commitments and improve accountability.

National Insurance Debt

1.22 Class 2 National Insurance is a flat rate contribution (currently £2.10 per week) paid by the self-employed. When HMRC is notified that a person is self employed, it assumes they will continue to be liable for these contributions until it is told otherwise. Inevitably, therefore some of the debt balances held on the HMRC systems will not be amounts genuinely owed – for example, where a person has ceased self-employment, but has failed to notify HMRC. In my report for 2004-05, I noted that HMRC's systems recorded £616 million outstanding National Insurance debt at the end of 2004-05 which was over six years old and therefore time-barred. HMRC concluded that of the £616 million recorded, £283 million was not actual debt and it also wrote off the balance of £333 million as time-barred.

1.23 HMRC sought to take urgent action to prevent further debts becoming time barred at 31 March 2006. But limitations in its computer system have hampered its ability to identify debt about to become time barred. HMRC has developed a strategy to ensure it manages these debts much more quickly in the future.

Tax repayments

1.24 In my 2004-05 Standard Report on the Inland Revenue I noted that a lack of formalised accountabilities had made it difficult for the Department to establish central oversight and responsibility, including the extent to which agreed controls over repayments were being operated. It also made it difficult to establish the degree to which these controls could prevent or detect error and irregularities. In response, the Finance Director has set up and chairs a Departmental Steering Group to establish central control and direction of HMRC's strategy on repayments and repayments security.

1.25 In the spring of 2006 Internal Audit reported that there were continuing weaknesses in HMRC's controls over tax repayments. On the basis of a sample of Self Assessment and Pay As You Earn (PAYE) repayments, Internal Audit estimated that taxpayers had potentially been overpaid £203 million and underpaid £45 million as a result of these weaknesses. In addition, they reported that underlying papers could not be found for 16 per cent of the sample of PAYE repayments. To strengthen operational controls, HMRC has issued guidance to staff reminding them of the importance of following the correct processes and retaining supporting papers. The Finance Director's Steering Group has a responsibility to ensure that this guidance is followed.

Other developments

Reform of the Construction Industry Scheme

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

1.27 In response to industry concerns about the cost of administering the 1999 scheme, in 2001, the Department began preparations for introducing a new Scheme designed to 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.

1.28 In October 2005, the Government announced that the scheme would be introduced in April 2007, two years later than originally planned. The implementation was postponed to provide more time for the industry to be ready for the launch of the new scheme.

Spend to raise

1.29 The Finance Act 1998 provides for me to examine and report on conventions and assumptions underlying the fiscal projections that are submitted to me by the Treasury for examination. As a result of measures announced in the 2003 and 2004 Budgets, the Inland Revenue introduced two new packages: (i) designed to promote taxpayer compliance; and (ii) to counter tax avoidance and fraud. For Budget 2006, I undertook a review of progress with the 2003 package.

1.30 I concluded in my review that the projections of additional revenue from the package were reasonable and incorporated caution, but that there were uncertainties and judgments underlying the projected impact. I therefore recommended that the projections should be revised if they appeared not to be cautious in practice. My review of progress with the 2003 package (HC 937, Session 2005-2006) showed that the projections made in the 2003 Budget did need to be adjusted to take account of both shortfalls and greater than expected yields in particular financial years in the period. There was a shortfall of £54 million in 2003-04, followed by surpluses of £32 million and £23 million in 2004-05 and 2005-06. The shortfall in the first year arose because:

- HMRC's processes for handling some cases of non-compliance did not initially operate as effectively as possible. The Department subsequently revised its procedures to improve the speed with which cases were handled;
- HMRC experienced some delays in recruiting the required number of appropriately experienced and qualified staff to undertake the planned work, and there were delays before some of the initiatives were fully operational;
- Some of the original assumptions supporting the forecast of future yields were too optimistic. These assumptions surrounded the levels of non-compliance that could be tackled under these initiatives.

PART TWO

TAX CREDITS

Introduction

2.1 Child and Working Tax Credits (tax credits) were introduced in April 2003[4] as part of the Government's reforms of the tax and benefits system aimed at relieving child and in-work poverty. They were designed to 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 Credit which were introduced in 1999, and the Children's Tax Credit, introduced in 2001.

2.2 During 2005-06, HMRC paid a net £17.3 billion in tax credits and an average of 5.3 million families received provisional 2005-06 awards. HMRC has estimated that 79 per cent of families with children entitled to tax credits in 2003-04 actually claimed awards; estimates for later years are not yet available. The cost of administering the scheme was £467 million (2004-05 £475 million).

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 designed to support working people, both employed and self employed, by topping-up earnings; the amount depends on factors such as age or the number of hours worked. Additional support is available for childcare costs or where a member of the household suffers from disability. To be eligible for tax credits claimants need to be present, ordinarily resident and have a right to reside in the UK. The rates payable for each element of Child and Working Tax Credit in 2005-06 are shown in **Figure 2**.

2.4 Some elements of Working Tax Credit were initially paid to claimants directly through their employers. From April 2006, these were replaced by direct payment from HMRC. Some families currently receive tax credit support for their children through income support and jobseekers' allowance. But the Government intends to provide all income-based support for children through tax credits in the future.

2.5 My recent Standard Reports have covered a number of important issues in the administration of tax credits, including overpayments and their recovery, levels of error and fraud, problems with the computer system and the operation of controls. This part of my report considers the progress HMRC has made in dealing with these issues and examines some new challenges it has faced in 2005-06. It covers:

- The tax credits scheme;
- Overpayments and underpayments; and
- Managing error and fraud.

1 Tax Credits: Scheme Overview

	2003-2004	2004-2005	2005-2006 (provisional[2])
Families benefiting[1]	4.6m	5.0m	5.3m
Of which: Child Tax Credit	4.4m	4.8m	5.0m
Working Tax Credit	1.6m	1.7m	1.8m
Net cash paid to claimants in year	£13.5bn	£15.8bn	£17.3bn
Final value of awards[3]	£12bn	£14.3bn	not available
Administrative cost to HMRC	£406m	£475m	£467m
Staff employed by HMRC	7,300	8,200	8,750

Source: HMRC

NOTES

1 Figures represent the average number of families benefiting in the year for 2003-04 and 2004-05 in finalised awards and for 2005-06 in provisional awards. Some families benefit from both Child and Working Tax Credits. These figures exclude families receiving child support through in-work benefits (2003-04 1.1 million, 2004-05 0.9 million, 2005-06 0.7 million).

2 Actual information for 2005-06 will be available in April 2007, after 2005-06 awards have been finalised.

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

4 The Tax Credits Act 2002.

2 Annual rates for tax credit elements

Tax Credit Element	2005-06 Annual Rates
Child Tax Credit[1]	
Family Element (one per family)	£545
Higher Family Element (in first year of child's life)	£545
Child Element (for each child)	£1,690
Disability Element (for each disabled child)	£2,285
Severe Disability Element (for each severely disabled child)	£920
Working Tax Credit[2]	
Basic Element	£1,620
Second adult and Lone Parent Element	£1,595
30 Hour Element	£660
Disabled Worker Element	£2,165
Severe Disability Element	£920
Element for claimants aged 50 and above, working 16-29 Hours	£1,110
Element for claimants aged 50 and above, working 30+ Hours	£1,660
Childcare Element – childcare costs cannot exceed £175 per week for one child and £300 per week for two or more children	70 per cent of costs

Source: HMRC

NOTES

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

2 An award is reduced by 37p for every £1 of annual income over £5,220.

The Tax Credits Scheme

2.6 The amount of tax credits paid by HMRC is based on an annual entitlement. HMRC calculates a provisional award and makes payment using the latest information it holds about the claimant. It makes a final assessment after the end of the year once the claimant's actual income and circumstances are known. Most awards are finalised in the period between April and September, but this may be as late as the following January if claimants submitted an initial estimate, for example where claimants do not finalise their self-assessment return until January.

2.7 Claimants must inform HMRC of changes in their circumstances. Some changes must be notified immediately, such as those that would bring an award to an end or significant reductions in childcare costs. Claimants can notify other changes after the end of the year, but HMRC encourages them to report as early as possible changes likely to affect their award so as to keep awards in line with entitlement. Changes in circumstances can result in both increased and decreased entitlement for the year in which the change occurred.

2.8 After the end of the year HMRC asks claimants to review their circumstances for the year on which their award was based, to notify it of any changes and to report their income for that year. HMRC then reassesses the award in the light of actual circumstances and income for that year. The final award can be higher or lower than the provisional award, for example where the final income is different from the provisional income.

2.9 HMRC pays the claimant a lump sum where it calculates that the provisional award resulted in an underpayment. Where the provisional award has resulted in an overpayment, HMRC seeks to recover it from future payments, subject to limits designed to protect the awards of low income families (as set out in paragraph 2.16 below) or, if there is no ongoing entitlement, directly from the claimant. An outline of the tax credit process is given in **Figure 3 overleaf.**

3 Overview of the tax credits process

Time	Actions by Claimant	Actions by HMRC
Before the start of the year	Claimant provides HMRC with details of income and circumstances	
		HMRC calculates a provisional tax credits award
During the year		HMRC makes provisional payments to the claimant
	Claimant may notify HMRC of change in their circumstances	
		HMRC calculates a revised award and amends payment to reflect the latest information.
After the year-end	Claimant informs HMRC of their actual circumstances for the previous year	
		HMRC finalises the award and pays underpayments as a lump sum or seeks recovery of overpayments.

Source: National Audit Office

2.10 When HMRC finalises awards it disregards any increases in claimant income over the previous year of up to £2,500 to limit the need for adjustments to the provisional award. HMRC estimates that final entitlements to Tax Credits in 2004-05 would have been around £700 million lower (£800 million in 2003-04) without the £2,500 'disregard'. The threshold below which income increases will be disregarded in calculating final awards will be increased to £25,000 for 2006-07 awards.

Overpayments and underpayments

2.11 Overpayments and underpayments are a feature of tax credits and occur where a claimant's income and circumstances change, for example between the calculation of the provisional and the final award.

Causes of overpayments and underpayments

2.12 The tax credit computer system does not automatically generate information on the underlying causes of overpayments and it would involve significant resources for HMRC to examine every award to determine why an overpayment occurred. HMRC's analysis of overpayments suggests that they result from a number of factors:

- income rises from one year to the next;
- families overestimating the extent to which their income has fallen when they seek extra support during the year;
- provisional payments made at the start of the tax year based on out of date information which is subsequently updated when the award is renewed; and
- delays in reporting changes in families' personal circumstances to HMRC.

Underpayments of tax credits primarily arise when claimants do not notify reductions in household income that would increase the award.

Levels of overpayments and underpayments

2.13 Tax credit awards for 2005-06 will not all be finalised until January 2007 and HMRC will not therefore be able to provide actual totals of overpayments and underpayments, or the number of families affected until after that date. It nevertheless estimates that the amounts will be broadly similar to those in 2004-05.

2.14 HMRC completed the final assessment of awards for 2004-05 in January 2006. As shown in **Figure 4**, it identified overpayments of some £1.8 billion to two million families and underpayments of £556 million to 900,000 families. Overpayments in 2004-05 were £400 million less than for 2003-04 because HMRC had more up to date information on claimants' income during the year. In addition improved performance of the tax credit system has meant that fewer overpayments are caused by processing or software error. 529,000 families received overpayments of £1,000 or more, accounting for over 70 per cent of the total overpaid. An analysis of the bands of overpayments and underpayments is provided in **Figure 5 overleaf.**

2.15 HMRC calculate that £395 million of overpayments relate to some 228,000 awards which were terminated because the claimant had not reported their actual 2003-04 income, failed to return a signed 2004-05 award notice or did not qualify for tax credits. HMRC also overpaid £144 million in respect of 285,000 awards that ceased during 2004-05.

Recovery of overpayments and write-offs

2.16 HMRC's approach to recovering overpayments is set out in its guidance to claimants.[5] It usually seeks immediate repayment where the claimant is no longer eligible for an award, although HMRC considers any request to pay by instalments. Where there is on-going entitlement, HMRC recovers overpayments from future tax credit payments. But HMRC restricts some recoveries made against the payment of future awards where it considers this would cause hardship and the maximum it recovers each year are:

- 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.

HMRC expects complete recovery of overpayments from 2003-04 and 2004-05 to take several years.

4 Tax Credits overpayments and underpayments

	2003-04	2004-05
Net cash paid to claimants in year	£13.5bn	£15.8bn
Families benefiting	4.6m	5.0m
Overpayments	£2.2bn	£1.8bn
Families affected by overpayments	1.9m	2.0m
Underpayments	£464m	£556m
Families affected by underpayments	0.7m	0.9m

Source: HMRC

2.17 HMRC seeks to recover overpayments wherever possible, but it may write-off the debt or restrict the rate of recovery if it considers that repayment would cause hardship. HMRC writes-off overpayments on the grounds of 'official error' where it has made a mistake and the claimant could reasonably have thought the payment was right. In April 2006, the Department published revised guidance for recipients of tax credits, to provide further details of what it means by "reasonable".

2.18 In 2005-06 HMRC wrote off £397 million of overpayments (£123 million in 2004-05). This was made up of £176 million for 2003-04 awards, £137 million for 2004-05 awards, and £84 million for 2005-06 awards. These amounts include £130 million written off in respect of organised fraud. In addition, a total provision of £1,370 million has been made in the Trust Statement account for overpayments on finalised 2003-04 to 2005-06 awards expected to be written off. An analysis of amounts written-off, provisions and amounts to be recovered is given in **Figure 6 overleaf.**

Recent changes to the tax credits system

2.19 The recovery of overpayments has caused difficulties for some claimants and HMRC has made changes designed to reduce hardship. Before November 2005, HMRC's computer systems automatically recovered overpayments, even if the claimants disputed them. In November 2005, HMRC adopted a manual process to suspend the recovery of any disputed overpayments until it had reviewed the case and decided whether or not the overpayment was recoverable. It plans to replace this manual arrangement with an automated process later this year.

5 COP 26, *What happens if we have paid you too much Tax Credits.*

5 Finalised 2004-05 awards overpaid or underpaid as at 5 April 2006

Band of overpayment or underpayment	Overpayments				Underpayments			
	Awards (thousands)		Value (£m)		Awards (thousands)		Value (£m)	
Up to £200	611	(448)	56	(41)	372	(274)	32	(24)
£200 to £500	454	(414)	150	(141)	219	(170)	72	(56)
£500 to £1,000	364	(388)	260	(280)	152	(124)	108	(88)
£1,000 to £2,000	293	(347)	414	(493)	102	(92)	143	(129)
£2,000 to £5,000	207	(243)	619	(725)	54	(47)	157	(136)
Over £5,000	29	(40)	196	(252)	7	(5)	43	(29)
Total	**1,958**	**(1,879)**	**1,696**	**(1,931)**	**906**	**(713)**	**556**	**(464)**

Source: HMRC

NOTES

1 Comparative figures for 2003-04 shown in brackets.

2 These figures are calculated as at 5 April and exclude overpayments arising from subsequent backdated payments. In 2003-04 overpayments arising from subsequent backdated payments were £0.3 billion, and for 2004-05 these are currently estimated at £0.1 billion. Figures may not sum due to rounding.

6 Recovery and write-offs of overpayments from 2003-04 and 2004-05

	2003-04	2004-05	Total
Overpayments	**£2.2bn**	**£1.8bn**	**£4.0bn**
Amounts written off by 5 April 2006	(£0.3bn)	(£0.2bn)	(£0.4bn)
Amounts recovered by 5 April 2006	(£0.8bn)	(£0.2bn)	(£1.0bn)
Debt to be recovered at 5 April 2006	£1.2bn	£1.4 bn	£2.6bn
Provision for doubtful debts for 2003-04 and 2004-05 overpayments at 5 April 2006	n/a	n/a	£0.9bn

Source: HMRC

NOTES

1 This table excludes amounts for 2005-06 awards, because overpayments for these awards will not be known for certain until they have been finalised.

2 n/a = not applicable.

3 Figures may not sum due to rounding.

2.20 The December 2005 Pre-Budget Report announced changes which were designed to provide greater certainty to claimants, particularly when families see a rise in income. HMRC estimates that these changes will eventually reduce the value of overpayments by one third. The principal measures in this package, including HMRC's assessment of their impact on the level of overpayments are:

- For awards for 2006-07 and subsequent years, HMRC will raise the level at which increases in income are disregarded when finalising awards from £2,500 to £25,000. This will reduce overpayments arising from income changes above £2,500;
- From April 2006, additional responsibilities have been placed on claimants to notify HMRC promptly of changes in circumstances that affect their awards. This will reduce overpayments caused by awards being based on out of date information;
- For awards for 2005-06 and subsequent years, the period which claimants have to finalise their awards will be reduced from 30 September to 31 August. This will reduce overpayments caused by new awards being based on out of date information and will shorten the period where payments are made to claimants who no longer qualify for tax credits;

- From November 2006, HMRC will apply automatic limits on the recovery of overpayments where awards are adjusted in-year following a reported change in circumstance. HMRC believe this may encourage more families to report in-year changes of circumstances; and
- From April 2007, when claimants report a fall in income during the year, their tax credit payments will be adjusted for the rest of the year. But HMRC will not make a one-off payment for the earlier part of the year. After the end of the year their award will be finalised and HMRC will make a further payment if appropriate. Amongst other effects, this should reduce overpayments where families overestimate the extent to which their income has fallen when they seek extra support during the year.

2.21 The Treasury estimates that the overall effect of the package on the net cost of the scheme to the Exchequer will be £100 million in 2006-07, followed by net savings of £200 million in 2007-08 and £50 million in 2008-09. It has not been able to provide reliable costings for the individual elements of the package. This is because it does not have comprehensive data to allow it to track individual awards on a continuous basis to identify and quantify precisely the contribution of each of the potential reasons that overpayments occur. In the absence of complete and certain information on tax credit overpayments in 2003-04, the costings are based on a number of policy-related assumptions about the impact of the measures, their likely interaction and their effect on claimant behaviour.

Managing error and fraud

Claimant Error and Fraud

2.22 HMRC 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 it checks these before or, in certain cases, after claims are paid. Since the introduction of tax credits HMRC has placed greater emphasis on identifying error and fraud before payments are made as the most effective way to avoid financial loss. **Figure 7 overleaf** illustrates the main process by which HMRC checks tax credit claims.

2.23 HMRC makes a number of pre-payment checks involving a series of steps, as set out in Figure 7, before authorising payment. All new tax credit claims, whether received on paper or over the internet, are subject to a series of verification checks and a risk assessment process. These involve:

- automatic verification of certain personal data claimants provide to check they are consistent with information that HMRC already holds for them. This verification check will not necessarily stop fraudulent claims involving stolen identities because the personal information provided in the claim is correct and matches the details held by HMRC.
- automatic risk assessment to identify high-risk cases, such as undeclared income, undeclared partners or fictitious child care costs. HMRC also checks for cases that display features of organised fraud. New claims posing the greatest risk are examined by the compliance unit before the awards are paid.

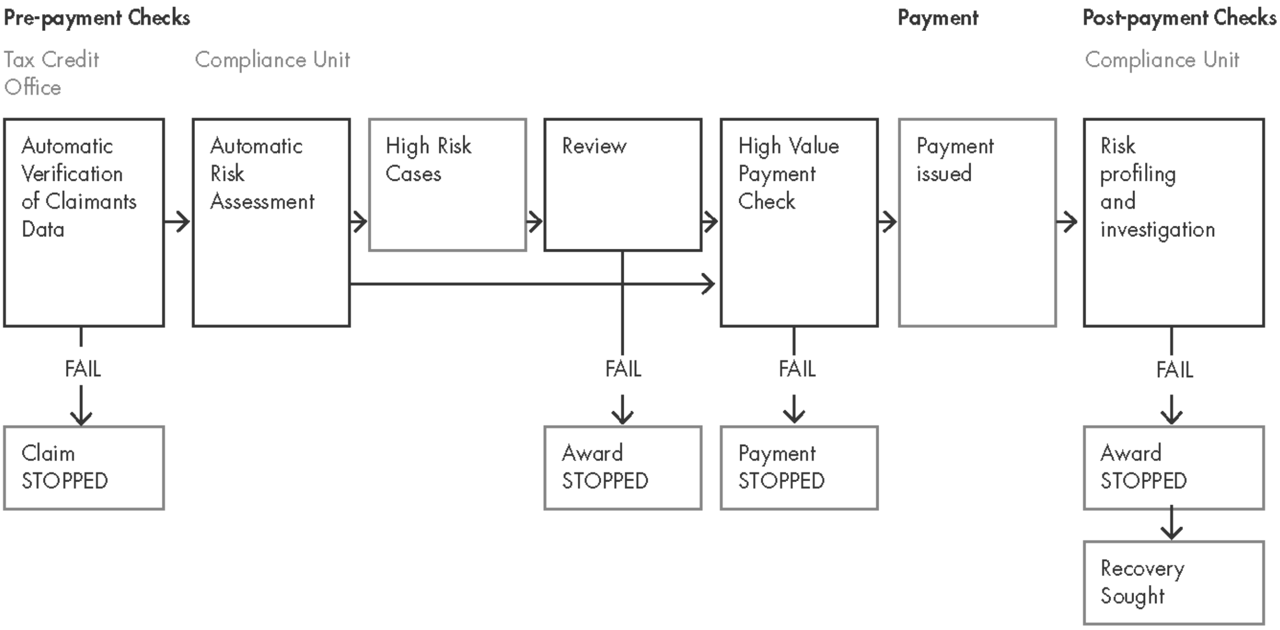
In addition, HMRC checks all payments over a certain value to identify any large payments that could indicate potential fraud. If the claim demonstrates known features of fraud HMRC stop the payment before it reaches the bank account.

2.24 HMRC carries out further checks once claims are in payment. It carries out computer based interrogations against all awards in payment to identify those showing characteristics of fraud or non-compliance. It takes action, including withholding payment and undertaking further enquiries, where it considers there is sufficient evidence of risk.

2.25 If HMRC identifies non-compliance, it corrects the claim and notifies the claimant to help avoid similar errors in future awards. For more serious cases, HMRC can impose a financial penalty and its Criminal Investigations Directorate may consider whether to recommend criminal proceedings[6]. In 2005-06, HMRC referred 1,721 cases to be considered for prosecution. Under Section 16 of the Tax Credits Act 2002, HMRC can also terminate payments without prior contact with the claimant where it considers there is evidence of potential organised fraud.

6 In April 2005, HM Revenue & Customs Prosecution Office became responsible for prosecutions in England and Wales. Responsibility in Northern Ireland and Scotland continues to rest with the Director of Public Prosecutions and the Procurator Fiscal.

7 Compliance Checks on new Tax Credit Claims



12 basic checks to verify claimant data.

The award will not go into payment if the claim fails certain key 'high severity' verification checks.

All new claims are scored against over 20 weighted risk criteria, applied independently and in combination, covering eligibility and other factors.

All claims scoring in excess of a pre-determined threshold ('high risk cases') are selected for review.

Review of High Risk Claims

The highest risk cases are identified for immediate compliance consideration. In cases taken up for full examination the claim will be rejected before any payment is made, if the compliance team are not satisfied that it is correct. High risk claims that are not considered for a full examination at this point will be picked up for post award action.

High Value Payment Check

All payments over a pre-determined threshold are checked against known features of organised fraud to confirm they relate to a genuine claimant.

Further intelligence driven profiling of genuine claimant population to identify claims demonstrating high risk characteristics as well as looking for known 'modus operandi' used by organised fraudsters.

Source: National Audit Office

2.26 HMRC's performance against its targets for compliance checks on tax credits is shown in **Figure 8 overleaf**. In 2005-06, HMRC's compliance teams carried out 146,000 pre and post payment checks on the highest risk claims, which yielded £528 million. During 2005-06 HMRC changed the balance of its pre and post payment checking by increasing the number of checks carried out before the payment of the highest risk claims. In 2005-06, 45 per cent of all claims checked by the compliance unit were checked prior to payment (16 per cent in 2004-05). To make best use of its resources, HMRC's compliance work is focussed on those claims it considers show the highest risk of non-compliance.

2.27 Throughout 2005-06 HMRC's pre-payment checking identified increasing numbers of claims which demonstrated the characteristics of organised fraud. In May 2005, it introduced weekly monitoring of cases classified as potentially organised fraud cases under its pre-award risk assessment process. The level of suspected organised fraud cases identified through this process gradually increased though 2005 to reach a peak in November and early December, as shown in **Figure 9 overleaf**. During this period the process of pre-payment checking came under heavy pressure, and HMRC directed a significant proportion of its compliance resources into checking suspected organised fraud cases. High risk claims that were not considered for a full examination at this point were reviewed post payment. In 2006-07, HMRC plans to dedicate at least a further 200 staff to its tax credit compliance teams and it has increased the target for the number of pre and post payment checks to 130,000.

2.28 As described in paragraph 2.25, in addition to direct checks by tax credit compliance teams, HMRC 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 the withholding of payments where the claimant fails to sign the award notice. An analysis of the outcomes arising from all HMRC actions to stop erroneous and fraudulent tax credit claims is given in **Figure 10 overleaf**. HMRC estimates that in 2005-06 it intervened in 195,000 cases and prevented payments of £447 million. The analysis also shows that HMRC found it had made incorrect payments of £250 million, including £131 million of suspected organised fraud.

2.29 In addition to the checks on all tax credit claims, HMRC also carried out compliance work in specific areas it assessed as having higher risks of error and fraud. In 2003-04 and 2004-05, HMRC carried out two special exercises to check child care costs with the providers who were contacted to verify the details provided by all claimants whose award included an element for child care costs. In 2005-06, following concerns from child care providers about the amount of work these checks involved, HMRC instead contacted providers only in cases where it identified a high risk.

Organised crime and the tax credits e-portal

2.30 Until December 2005, tax credit claims could be made through the internet (the tax credits e-portal) or on paper. The ability to claim tax credits through the e-portal was particularly appealing to organised criminals as it allowed them to quickly submit multiple claims with anonymity. HMRC has always been aware of the risk that organised criminals may attempt to make fraudulent tax credit claims. As part of its pre-award checking, it has developed specific checks designed to identify applications that display the features of organised fraud.

2.31 HMRC first became aware that attempted fraud through the e-portal was an emerging problem at the end of 2004, although it considered these risks could be managed through its existing compliance work. From April 2005, however, it began to see a growing threat of organised fraud through the tax credits e-portal, when its pre-award checks began to identify an increasing numbers of claims with the characteristics of organised fraud. In June 2005 HMRC advised its Ministers of this problem although it continued to consider that its existing controls were sufficient to manage the threat. The pattern of claims made each week can be subject to significant variation. However, throughout this period the volume of claims made through the tax credits e-portal had remained below 10,000 per week. HMRC found that the volume of claims made through the e-portal began however to rise significantly from August 2005 and by November 2005 these had reached some 30,000 per week as the system came under sustained attack. HMRC reassessed the risk of fraud against the tax credits system and it closed the e-portal on 2 December because of the increase in the volume of claims, the increased number of claims showing the characteristics of organised fraud, and new information from the Department of Work and Pensions that organised criminals were in possession of large numbers of stolen identities. HMRC's other online services were unaffected.

8 HMRC's direct compliance checks *(targets shown in brackets)*

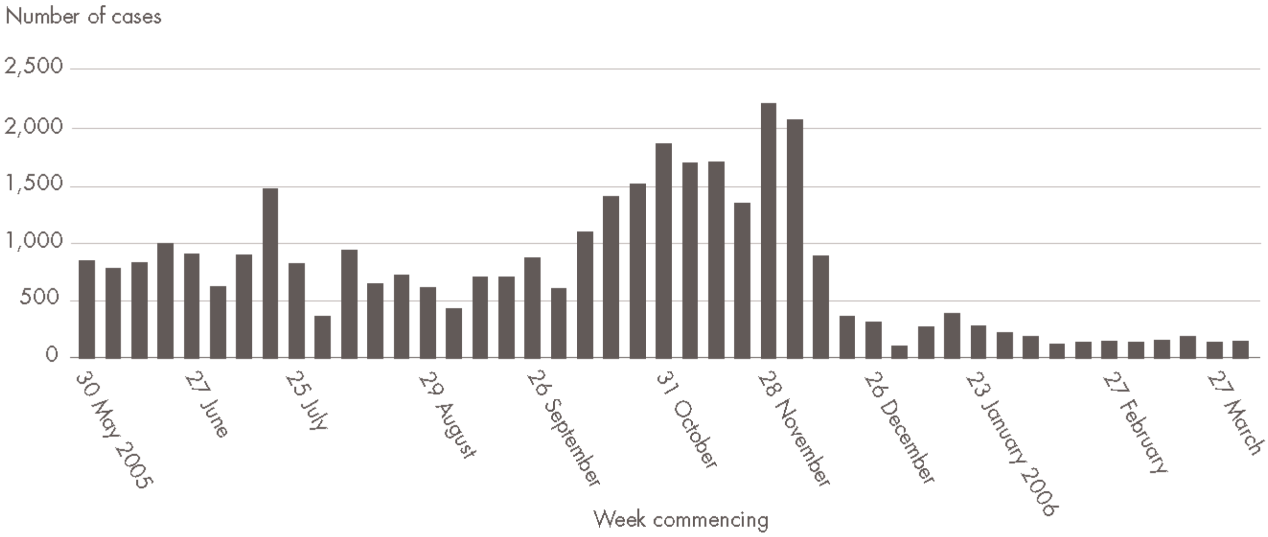
	2004-05	2005-06
Volume of Checks		
Pre and post payment checks	107, 789 *(101,500)*	146,376 *(110,000)*
Pre payment : post payment ratio	16% : 84%	45% : 55%
Effectiveness of checks		
Yield	£130m *(HMRC did not set a target for yield in 2004-05)*	£528m[1] *(£143m)*
Checks resulting in change to award:		
Pre award	93%	93%
Post award	65%	85%
Sanctions		
Cases where a penalty was charged	1,114	2,241
Total value of penalties	£445,645	£887,585
Criminal prosecutions	211	289

Source: HMRC

NOTE

1 Yield includes incorrect payments identified by HMRC of £221 million in 2005-06.

9 Potential organised fraud cases identified by HMRC's pre payment checks



Source: HMRC

NOTE

This figure shows the weekly intake of high risk cases on HMRC's pre-payment worklists which were classified as potential organised fraud. Data was not collected in this format before May 2005.

10 Outcome of all HMRC compliance and other actions on tax credits fraud and error cases in 2005-06

	Overall			Suspected Organised Fraud		
	Compliance actions thousands	Incorrect payments identified £m	Incorrect payments prevented £m	Compliance actions thousands	Incorrect payments identified £m	Incorrect payments prevented £m
Pre Award						
Compliance checks	67	nil	219	58	nil	200
Other actions	33	nil	113	33	nil	113
Total	**100**	**nil**	**332**	**91**	**nil**	**313**
Post-Award						
Compliance checks	80	221	88	37	102	69
Other actions	15	29	27	15	29	27
Total	**95**	**250**	**115**	**52**	**131**	**96**
Pre and Post Award						
Compliance checks	147	221	307	95	102	269
Other actions	48	29	140	48	29	140
Total	**195**	**250**	**447**	**143**	**131**	**409**

Source: HMRC

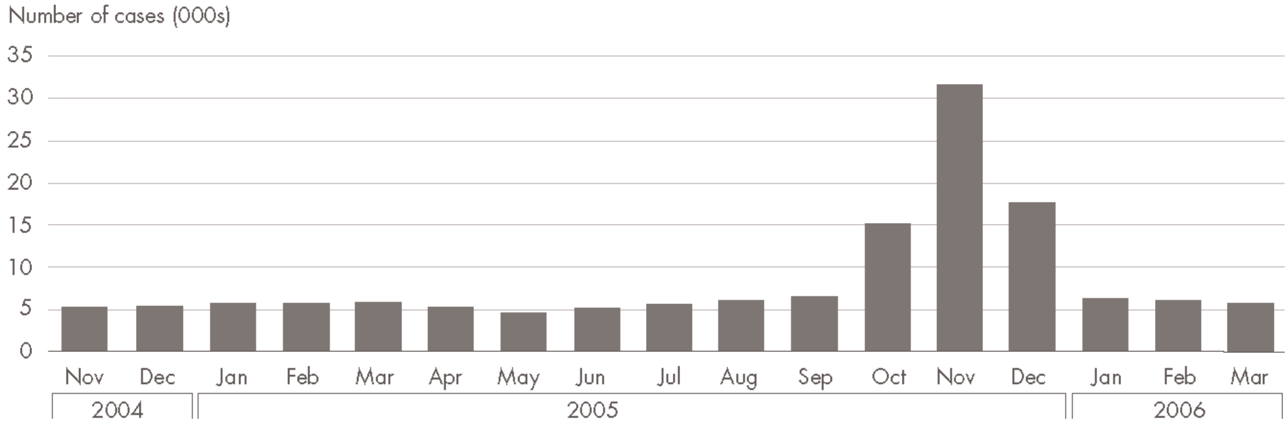
NOTE

The estimate of incorrect payments identified represents the value of payments made prior to the compliance or other action taking place. The estimate of incorrect payments prevented is the additional amounts that would have been paid for 2005-06 had payment not been withheld.

2.32 Following the closure of the e-portal, HMRC has assessed the extent of the attacks on the tax credits system from organised criminals. Using knowledge gained from the attacks, it has reviewed all claims that were made through the tax credits e-portal in 2005-06 which shared the characteristics of the claims from organised fraudsters. It estimates that in late 2005 some 62,000 fraudulent claims were made through the e-portal using stolen identities, of which 33,000 were successful and passed into payment at a cost of around £55 million. This includes some 13,000 claims made using the identities of DWP and Network Rail staff, of which 7,000 were successful at a cost of around £10 million. HMRC has no evidence that the other attacks were based on the use of information systematically stolen from any one employer.

2.33 Based on this work, HMRC believes there were around 5,000 to 6,000 genuine claims in payment in the first nine months of 2005 which had the same characteristics as the actual cases of organised fraud in late 2005. The analysis, as shown in **Figure 11 overleaf**, shows that the system came under heavy attack in November 2005 when fraudulent claims through the e-portal reached a peak of 33,000. The numbers fell in December 2005 following investigations by HMRC's compliance teams to stop payments. In 2005-06 HMRC stopped 143,000 suspect tax credit applications by organised fraudsters and it estimates that £131 million was lost due to organised fraud.

11 Tax Credit cases in payment containing characteristics used in attacks by organised criminals in late 2005



Source: HMRC

NOTE

This figure shows the number of tax credit cases in payment which shared the characteristics used in the fraudulent claims submitted as part of the organised attack in late 2005, including around 5,000 - 6,000 genuine cases.

2.34 At the time of my report, HMRC's Organised Tax Credit Fraud Strategy Board was overseeing investigations into 41 separate organised fraud cases, the majority of which involve multiple claims based on stolen or false identities. HMRC cannot yet give a precise figure on the overall sums involved, but its initial indications are that the total losses on these cases were £26 million. HMRC is conducting further work to establish firmer estimates of the frauds and whether prosecutions are possible. By June 2006, it had completed four prosecutions for organised fraud through the criminal court, which resulted in eight convictions and confiscation orders of £1.4 million.

2.35 HMRC assessed that the tax credits e-portal complied with its internal security standards when it was introduced in August 2002. But it has accepted that additional controls need to be built into the tax credits e-portal before it can be re-opened to the public to conform to subsequent guidance issued by the Office of the e-Envoy for the registration of new users and the authentication of their identity each time they access the service[7]. Whilst the tax credits e-portal required limited verification of the claimant's identity against HMRC's records, claimants did not have to produce documentary evidence to prove their identity and address, such as a passport or bank statement.

2.36 HMRC has considered how organised fraudsters might respond to the closure of the tax credits e-portal by attacking other channels. It has strengthened its controls over handling paper-based claims and has revised its procedures to improve controls over claimants' notification of changes of circumstances which affect their awards. It has also provided training to promote fraud awareness to contact centre staff and embedded compliance specialists within contact centres to prove additional support and specialist knowledge to these staff. HMRC intends these changes to create more of a 'challenge' function when handling tax credits claims in the future.

Measuring the level of error and fraud

2.37 In addition to its day to day management of compliance risks, HMRC also measures the overall level of error and fraud by investigating a random sample of awards, although the design of the tax credits scheme affects the speed with which it can complete this work. Under the Tax Credits Act 2002, HMRC cannot commence its investigation into randomly selected awards until they have been finalised. While most awards for 2003-04 were finalised by the end of September 2004, some could not be finalised until the end of January 2005 if taxpayers submitted an initial estimate. HMRC could not therefore start its investigation of some cases until February 2005.

7 In September 2002, the e-Envoy issued guidance on controls that should be built into systems where government services were provided electronically, *Registration and Authentication: e-Government Strategy Framework Policy and Guidelines*.

2.38 In June 2006, HMRC completed its testing of 2003-04 awards, based on a sample of some 4,500 random enquiries against claimant records. As a result of this, HMRC estimates that claimant error and fraud resulted in between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value) being paid to claimants to which they were not entitled. It also estimates that claimant error resulted in between £190 million and £280 million (1.6 to 2.3 per cent by value) not being paid to claimants to which they were entitled. As separately noted in my report on the 2005-06 Trust Statement, I concluded that this level was unacceptably high and, as there is currently no evidence to justify a lower estimate for 2005-06, I have qualified my audit opinion on the Trust Statement account in respect of tax credits.

2.39 In conducting random enquiries of awards, HMRC tries to strike a balance between the risk of not detecting error and fraud and undue intrusion into claimants' circumstances. It decides on the level of enquiry based on an assessment of the risks of error and fraud in each case. My staff found that HMRC's work was primarily focused on identifying overpayments and that it did not always fully consider the risk of error leading to underpayments. 2003-04 was the first year HMRC undertook this work and it has introduced the following steps to learn from its experience:

- providing additional guidance to its compliance staff, emphasising the importance of undertaking a full enquiry;
- carrying out additional validation checks of the work of compliance staff, with detailed management review of all cases and independent reviews of randomly selected cases;
- closer working between tax credit and self-assessment teams within HMRC; and
- coaching individual staff who could have carried out more thorough work.

Administrative Error

2.40 Incorrect awards and payments can be made due to errors made by HMRC. It has established procedures intended to prevent errors in the first place and to identify any that do arise.

Processing accuracy

2.41 HMRC checks how accurately it processes information received from claimants by re-examining a sample of cases against the original information provided. This work was in progress at the time of my report, but **Figure 12** shows the provisional results of this review and highlights that HMRC should exceed its Public Service Agreement target of processing accurately 95 percent of claims and changes in circumstances. It has made significant improvements in processing information accurately since the introduction of tax credits, which reflect its continuing efforts to identify the reasons for inaccuracy and to introduce new procedures to prevent error. HMRC considers that the small sample size and low error rate means it cannot provide a statistically valid assessment of the financial effect of inaccurate processing and that a larger sample size would involve a disproportionate amount of resource. The Department's research indicated that the three main reasons for inaccurate processing were: incorrect amendments to historical records; inputting of incorrect income; and / or inputting of incorrect child care costs.

2.42 My staff reviewed the accuracy of HMRC's checks on its processing. They were satisfied that the work was undertaken properly but found that in 15 per cent of cases HMRC was unable to locate documents it had selected for testing and these items were excluded from the results. HMRC replaces cases that cannot be found with another randomly selected item, and there is no evidence that the cases where documents are lost are less accurate than those HMRC was able to check. HMRC plans to improve how it maintains this information.

12 Accuracy of processing and calculating tax credit awards

	2003-04 %	2004-05 %	2005-06 % *(provisional)*
Target	90.0	90.0	95.0
Actual	78.6	96.5	98.3

Source: HMRC

Software errors

2.43 HMRC has recovered significantly from the early problems with its tax credits computer system, although at the end of October 2005, there were still 199 known software errors which potentially caused errors in payments. In October 2005, HMRC started a systematic review of all these errors to calculate the value of overpayments and underpayments they have caused. The Department has an ongoing programme of prioritising and correcting the underlying errors.

Reconciling the information held by the HMRC

2.44 HMRC also seeks to confirm the accuracy of its information by reconciling the different sources of information it holds and by comparing this with information held by third parties.

2.45 In my previous reports, I noted that HMRC had not been able to perform the planned daily reconciliation of payments made against payments authorised. This is important as any differences indicate that an incorrect payment may have been made. As an alternative process HMRC performed checking retrospectively but this meant that some incorrect payments were not promptly identified. In November 2005, HMRC introduced an automated daily check of payments made against payments authorised, which should help it identify incorrect payments more quickly. But the new process suffered initially from computer difficulties and HMRC had to continue with some aspects of its old approach. HMRC has taken action to address these problems and considers that the system is now performing as intended.

2.46 In 2005-06, HMRC made adjustments to its record of payments authorised of £8.2 million (2004-05 £7.9 million). But, it did not fully understand the causes of the discrepancies. HMRC has subsequently undertaken detailed work to understand how these problems arose and to address the faults. It has found that the number of discrepancies has now reduced substantially.

2.47 HMRC continued to have difficulty in reconciling its own record of payments with those of its bank, largely because of limitations in the information produced by the Tax Credits computer system. In April 2006, HMRC enhanced the quality of information available, which has improved the bank reconciliation process and a further improvement is due in November 2006.

Controls over tax credit payments made by employers

2.48 Until April 2006, some elements of tax credits were paid directly to claimants through their employer. HMRC needs assurance that the amounts paid by employers conform with the actual award it has made. Since the introduction of Tax Credits in 2003, HMRC has found that employers' end of year returns have not provided sufficient information to allow a full reconciliation of amounts paid by employers against awards made by HMRC. The Department has instead sought to obtain assurance that the amount paid is correct by selecting a sample of employer records and reconciling the amounts reported as paid by the employer to its own record of awards.

2.49 The 2004-05 reconciliation was completed in December 2005 and showed a reconciliation rate of 77.4 per cent compared with 78.9 per cent for 2003-04. HMRC was unable to reconcile the remaining 22.6 per cent and required employers to correct awards where it found errors. The exercise indicated that of the total £1.6 billion paid by employers in 2004-05, there was a likely net underpayment of £44 million (within an estimated net range of £18 million underpaid to £70 million underpaid). The 2005-06 reconciliations were in progress at the time of this report.

Conclusions

2.50 The tax credits system was changed in April 2003 and in 2005-06 HMRC paid a net £17.3 billion to tax credit claimants and an average of 5.3 million families received provisional 2005-06 awards. HMRC uses the latest information it holds on claimants to calculate a provisional tax credit award and make payments. It makes a final assessment after the end of the year when the claimant's actual circumstances are known. The final award is often higher or lower than the provisional award, for example because the final income differs from the provisional income.

2.51 HMRC estimates that it overpaid £1.8 billion and underpaid £556 million in tax credits in 2004-05 and that the position for 2005-06 awards will be similar. When HMRC identifies an underpayment it pays the claimant a lump sum and it seeks to recover overpayments from future awards or, if there is no ongoing entitlement, directly from the claimant. The recovery of overpayments has caused hardship to some families and HMRC has struggled to manage disputes about recovery. It cannot recover all overpayments and in 2005-06 wrote off £397 million and made a provision of £409 million for doubtful debts.

2.52 The December 2005 Pre-Budget Report announced changes to the tax credits system which were designed to provide greater certainty to claimants, particularly when families see a rise in income. One important change will be to raise from £2,500 to £25,000 for 2006-07 awards the threshold for increases in income which will be disregarded when provisional awards are re-assessed. There will also be new responsibilities on claimants to tell HMRC promptly about changes in their circumstances. The Treasury has been unable to provide reliable costings for the individual elements of the package. The success of these measures in reducing overpayments and recoveries will become apparent only in 2008 following finalisation of 2006-07 awards.

2.53 HMRC estimated that in 2003-04 claimant error and fraud resulted in tax credits of between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value) being paid to claimants to which they were not entitled. It also estimates that claimant error resulted in between £190 million and £280 million (1.6 to 2.3 per cent by value) of tax credits not being paid to claimants when they were entitled to them. These are the first full results for the scheme since it was introduced in April 2003. These levels are unacceptably high and there is currently no evidence to justify a lower estimate for 2005-06. Consequently, I have qualified my opinion on the Trust Statement. Now HMRC has a baseline figure, it needs to target future reductions in levels of error and fraud.

2.54 HMRC tries to maintain a balance between accessibility of the tax credits 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 it checks these before or after claims are paid. In 2005-06, HMRC completed compliance checks and other actions against 195,000 claims, identifying incorrect payments made of £250 million and preventing incorrect payments of £447 million. HMRC prioritises its compliance activity on the claims it considers represent the highest risk. High risk claims that are not fully examined before payment are selected for checking after payment. HMRC has set a target for this compliance work which is based on the number of checks. It needs to consider how these can be developed into outcome based targets, such as reductions in fraud to provide better information on the effectiveness of its compliance work.

2.55 In 2005 there was a serious attack on the tax credits system by organised criminals submitting false claims using stolen identities. HMRC identified incorrect payments of around £131 million in 2005-06. Its Organised Fraud Strategy Board is overseeing investigations into 41 separate organised tax credit fraud cases, most of which involve multiple claims using stolen identities. HMRC cannot yet give a precise figure for the overall sums involved, but its initial indications are that the total losses on these cases were £26 million. HMRC is conducting further work to establish firmer estimates to support the case for prosecution.

2.56 HMRC closed the tax credits e-portal on 2 December 2005 as a consequence of these attacks and it accepts that additional controls need to be built into the e-portal before it can be re-opened. HMRC needs to ensure that the new system fully complies with established government standards on security. HMRC has reviewed the other channels through which tax credits can be claimed and has introduced new measures to safeguard against fraud. It needs to continue to assess the wider implications of the fraud and how organised criminals might respond to the closure of the tax credits e-portal.

PART THREE

THE COLLECTION OF INCOME TAX THROUGH PAY AS YOU EARN

Introduction

3.1 Pay As You Earn (PAYE) was introduced in 1944 and collects tax on income from employment and pensions at source. In 2005-06 HMRC collected £114 billion income tax (£109 billion 2004-05) through PAYE, the largest source of tax revenue, from some 41 million employment and pension sources operated by 1.9 million PAYE employer and pension schemes. HMRC employs some 15,000 staff in directly administering PAYE.

3.2 The PAYE process is designed so that employees and pensioners pay the right amount of tax in the tax year, so the only cases which need to be reviewed at the end of the year are those where that has not been possible. HMRC estimates that, in practice, the PAYE system handles about 70 per cent of cases automatically without the need for further work by the Department. Of those cases that need to be reviewed, HMRC's objective is to close as many as possible within a year after the end of the tax year. Although this is not stated as a formal business objective, HMRC aims to ensure that individuals who receive earnings pay the right amount of tax and to make it as easy as possible for employers and employees to meet their obligations.

3.3 HMRC's principal computer systems for administering PAYE were introduced in the 1980s. Since that time the size and complexity of the UK labour market has grown significantly and the number of PAYE schemes has increased. Over the same period additional requirements have been placed on employers through the mechanics of the PAYE system. HMRC and employers have therefore been faced with increased volumes of more complex transactions to process through the PAYE system.

3.4 My Standard Report for 2004-05 commented on some of the work carried out by HMRC's Internal Audit and highlighted that 3.8 million taxpayers could have paid too much or too little tax because HMRC was not calculating tax liabilities correctly, in particular where individuals had more than one job at the same time. This part of my report covers:

- The PAYE process;
- Challenges faced by HMRC in operating PAYE;
- Weaknesses and inconsistencies in HMRC's processes and operations;
- The effect of those challenges; and
- Action being taken by HMRC to improve the PAYE process.

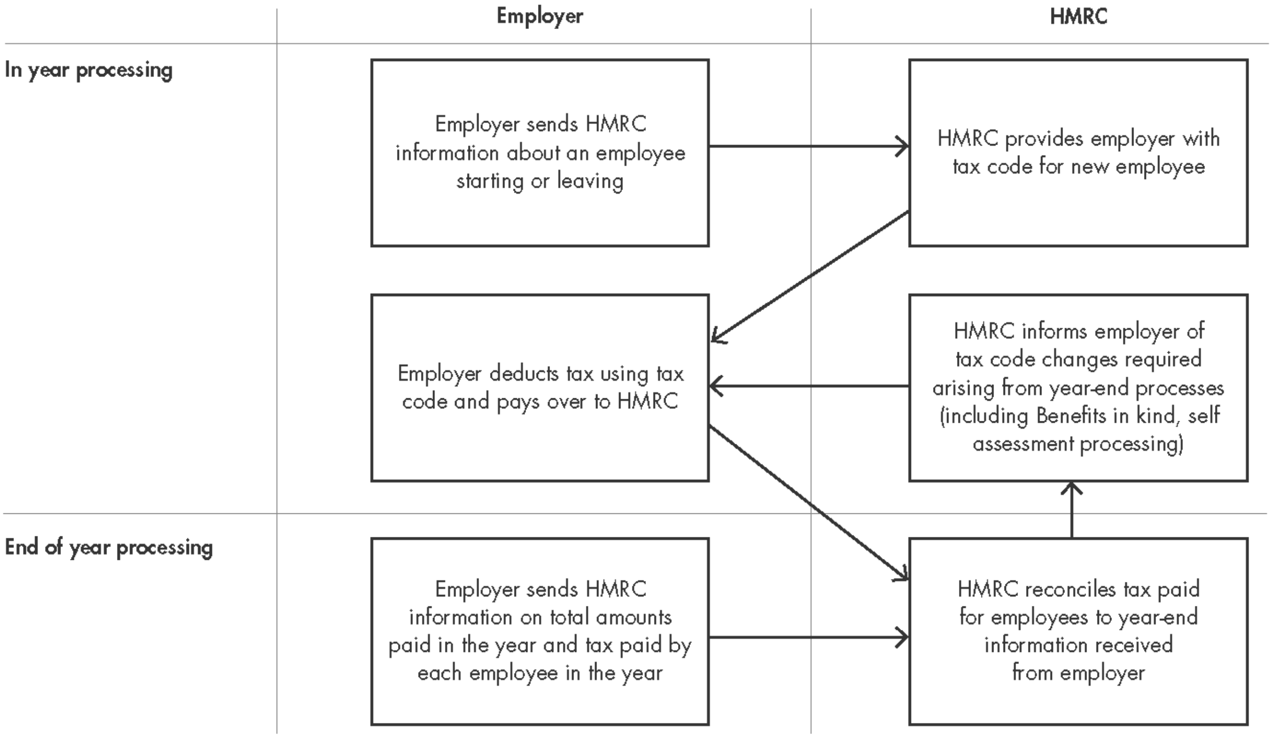
The PAYE Process

3.5 Employers are responsible for administering PAYE schemes on behalf of HMRC, ensuring that the correct amounts of tax and national insurance contributions are deducted from employees' earnings and paid over to HMRC. PAYE involves a number of processes designed to ensure that taxpayers pay the right tax **(see Figure 13)**.

3.6 PAYE is designed to work such that the total tax deducted from earnings up to any point in the year is the correct proportion of total tax likely to be due for the whole year. To achieve this, HMRC issues a tax code for each employee, where necessary, to help the employer to calculate how much tax to deduct from the earnings week by week or month by month. Tax Codes are determined by individual taxpayers' circumstances and are revised to reflect relevant changes notified to HMRC.

3.7 When an employee changes jobs, the new employer needs certain information to deduct the right amount of tax from earnings. Employers are required to issue a form P45 to an employee who leaves a job, showing total earnings, tax deducted to date and their tax code. The individual should present the form P45 to a new employer to allow the right amount of tax to continue to be deducted from earnings. When a new employee is unable to produce a form P45, an employer instead sends a form P46 to HMRC with information about the new employment. HMRC uses this information to trace

13 The PAYE process



Source: National Audit Office

previous tax records, check the employee's circumstances, update its records and issue the new employer with a tax code if necessary. In the interim, the employer uses one of a limited number of codes, based on the information provided by the employee, for example, whether they have more than one job.

3.8 HMRC relates tax payments received in the year to individual employees when it has received and processed employers' annual PAYE returns. These returns show total earnings and tax deducted under each PAYE scheme (form P35) and information on individual employees (form P14). HMRC reconciles the amounts actually paid by employers to this information and records tax paid by individual taxpayers.

3.9 Employers also inform HMRC of expenses and benefits in kind, such as a company car or private health care, provided to employees in the year. HMRC enters this information onto its computer systems and checks if the individual has paid the correct amount of tax. The tax code is updated if necessary to reflect the latest information. If HMRC finds that additional tax is payable, it may adjust the tax code for a subsequent year to collect the balance through the PAYE system, or the individual can pay the amount in full immediately. HMRC repays any overpayments of tax.

Expansion of the scope of PAYE

3.10 PAYE was originally set up in 1944 with the limited objective of collecting income tax. The scope of the PAYE system has been expanded to cover the collection of certain self assessment liabilities, student loan repayments, accounting for statutory payments, and - until April 2006 – the payment of tax credits via employers. **Figure 14 overleaf** sets out the changes which have increased the task of administering PAYE.

14 Expansion of the PAYE system

1944	Introduction of PAYE to collect income tax
1948	Collection of National Insurance Contributions
1976	Changes in taxation of Benefits in Kind
1983	Statutory sick pay
1987	Statutory maternity pay
1997	Introduction of Self Assessment
2001	Collection of Student loan repayments.
2002	Tax credit payments to employees.[1]
2003	Statutory adoption and paternity pay

Source: HMRC

NOTE

1 Payment of Tax Credits via employers was withdrawn in April 2006.

Online filing of PAYE Returns

3.11 In April 2002, the Chancellor of the Exchequer announced that the Government would implement the recommendations from the first Review of Payroll Services by Lord Carter of Coles to introduce online filing of employers' end of year returns. Regulations were introduced requiring online filing of large and medium employers' end of year returns and encouraging, currently, voluntary online filing by small employers. In 2003, HMRC established a Modernising PAYE Processes for Customers (MPPC) Programme to provide the new business processes and support employers in meeting their new responsibilities.

3.12 Phase one of the MPPC programme concentrated on implementing Lord Carter's recommendations and the online system opened on 6 April 2005. In 2005-06, HMRC received some 935,000 annual returns (form P35) online (over 60 per cent), compared to some 85,000 (6 per cent) of returns filed online in 2004-05. HMRC's early indications are that, of the approximately 1.6 million employer returns received for 2005-06, about three quarters are being filed online.

3.13 In accordance with legislation[8], HMRC implemented an incentive scheme[9] to encourage small employers to file online, but found in its initial stages the scheme was abused by a small number of employers who artificially split their payroll to claim the incentive several times. The original regulations contained anti-abuse provisions covering incentive payments but in March 2005 the Government changed the regulations with the intention of strengthening defences against such abuse[10]. HMRC is also investigating whether some returns were submitted in circumstances where no return was strictly due. It considers there are probably fewer than 100 cases of potential abuse, out of the population of 1.9 million employers. In 2005-06 HMRC paid in total £225 million in incentives, £250 per small employer.

3.14 HMRC introduced a new computer system to process automatically online returns for 2004-05. But the implementation of this system was delayed causing significant backlogs of returns, some of which required manual processing. Most of these backlogs have now been cleared but at the end of May 2006 there were some 3.7 million items (around seven percent of the total) which had not been processed onto the PAYE system. HMRC expected to have cleared the majority of these in July 2006, apart from a small proportion of cases (some two per cent) which arise each year that require clerical action to clear.

3.15 Lord Carter's second review was published in March 2006 and it 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. HMRC plans to implement this as part of its future work on MPPC.

Challenges faced by HMRC in operating PAYE

3.16 HMRC's computer system for administering PAYE was introduced in the early 1980s and automated the manual processes in operation at that time. It is structured around individual employments and does not automatically bring together all the information for a particular employee. HMRC considers this may reflect the fact that the original PAYE mechanism was designed at a time where individuals generally had one source of income and a relatively stable employment history. As a consequence of changes in working patterns, HMRC's records on employees may be fragmented, particularly if they have more than one job or change jobs during the year. The problems associated with this have been exacerbated in recent years following changes in size and complexity of the labour market, and the growth in the UK employer population. There is also evidence that employers and employees are not following PAYE procedures.

8 Section 143 and Schedule 38 of the Finance Act, 2000.
9 Regulations covering incentive payments are in SI 2003/2495.
10 SI 2005/826 added further anti-abuse provisions to regulation 4 of SI 2003/2495.

Changes in size and complexity of the labour market

3.17 HMRC and employers are now administering PAYE for more people. The size of the UK workforce has increased steadily from 25.3 million in 1993 to 28.7 million[11] in 2005, which has produced more work for HMRC and employers in administering the PAYE system.

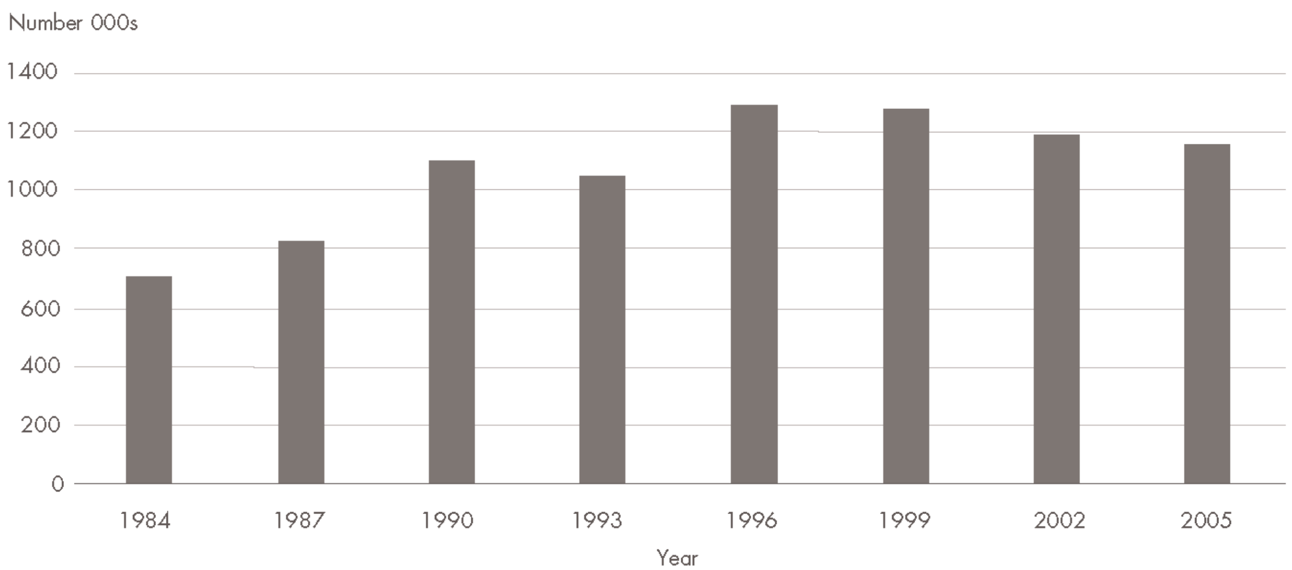
3.18 There are growing numbers of taxpayers with temporary reference numbers, which makes it difficult for HMRC to associate the information it receives against individual taxpayer records. HMRC creates a temporary reference number for each employment where an individual's National Insurance number is not known. This is usually because a new employee fails or is unable to provide an employer with a National Insurance number on starting work. This includes non-UK nationals entering the UK to work for the first time who will not have a National Insurance number.

3.19 HMRC takes action to clear temporary reference numbers, but the volume of them is currently growing at a faster rate than HMRC are clearing. In 2005, there were 7.7 million temporary reference numbers and HMRC estimates that this is growing by over one million a year. It estimates that in 4.2 per cent of these cases the same individual had more than one temporary reference number. This increases the risk that incorrect amounts of tax will be deducted as HMRC may not be able to bring together a complete picture of an individual's employments.

3.20 ONS Labour Force Survey data show that for any one quarter in 2005 there were some one million workers with income from more than one employment **(Figure 15)**. Although this is slightly below the levels recorded in the mid-1990s, it is significantly greater than the numbers of individuals with more than one employment at the time the PAYE systems were computerised in the 1980s. HMRC has 4.2 million computer records for sources of PAYE income which are not the main source of income for the individual concerned. As the PAYE computer system is based around employments rather than employees, HMRC can be unaware that there is another source of income when checking if the correct tax has been paid in these cases.

3.21 There has been a growth in employment of groups for whom PAYE is difficult to operate, including students who either have more than one job or frequently move jobs. HMRC believes that around 1.8 million full time students held a job at some time during 2005. The growth in taxpayers with multiple sources of income has also been fuelled by increasing numbers of working pensioners, which rose from eight to ten percent of the pensioner population between 1993 and 2005 and there are now 1.1 million working pensioners.

15 Employees with multiple jobs 1984-2005



Source: ONS Labour Force Statistics

11 ONS Labour force statistics.

Changes in the UK employer population

3.22 In addition to the increasing complexity of the UK workforce, the volume and complexity of the UK employer population has increased. The number of PAYE schemes is currently growing by approximately 100,000 (net) each year and there were 1.9 million PAYE schemes in 2005. HMRC considers that this increase is due to a number of factors, such as economic growth and more small company incorporations.

3.23 Along with growth in the number of PAYE schemes, there is a greater diversity of schemes and how they are operated. The largest 10 per cent of employers account for 94 per cent of tax receipts, but the vast majority of schemes are very small with fewer than five employees. Employers are also making more use of third party agents to administer their payroll operations and HMRC's information indicates that 24 per cent of employers now use an agent. HMRC considers this is a helpful trend, as third parties have specialist skills and knowledge in administering PAYE.

Difficulties in operating the system

3.24 HMRC relies on employers and employees providing timely and accurate information to enable it to administer the PAYE process. But the quality of this information varies considerably, presenting HMRC with an increased workload in order to maintain up to date and accurate information on individuals.

3.25 The process for tracking movements in employment is not always providing HMRC with the information it needs to maintain a complete picture of an individual's tax affairs. Turnover in the workforce is high; approximately 20 per cent of jobs last less than one year and 5 per cent are for periods of less than three months. HMRC's management information shows that about 70 per cent of employees starting a new job do not immediately provide their new employer with a P45 form carrying their National Insurance number and information about previous pay and tax. This may be because the P45 form has not yet been issued by the previous employer, it has been lost or mislaid, or because the employee has chosen not to provide it. This creates the risk that the new employer may deduct incorrect amounts of tax or that the correct National Insurance number is not used. HMRC has also found that the quality of information it receives from employers on job movements varies and that some large employers continually submit incorrect forms, including failure to provide important information such as National Insurance numbers. Even when the correct forms are submitted, they are often incomplete. These problems hinder HMRC's ability to process this information against its own records. The Department estimates that, in 2004-05, it failed to match four million records to a known individual at the first attempt and had to ask the employer and/or the employee for more information. Some HMRC offices contact employers who regularly submit inadequate information to explain what is required and to monitor their future performance. HMRC plans to extend this nationally.

3.26 Employees do not always respond to HMRC's requests for information. If HMRC does not have a complete history of a taxpayer - for example following a break in employment - it sends them a form P91 to try to obtain this information. But currently less than 30 per cent of these forms are returned. In such cases it is likely that the taxpayer will not pay the right amount of tax.

3.27 Employers are not always following HMRC's instructions to amend tax codes. HMRC notifies employers of changes to tax codes to ensure that the right tax is deducted. HMRC's Internal Audit reviews identified that employers were not always using the latest tax code despite being instructed to do so. This increases the risk that employees are paying incorrect amounts of tax and may necessitate further work by HMRC to repay any overpayments or collect any underpayments.

Weaknesses and inconsistencies in HMRC's processes and operations

3.28 HMRC's problems in administering PAYE have been aggravated by weaknesses and inconsistencies in its own approach. These include inadequate management information, the relative priority given to PAYE work as against other operational demands and failure by staff to comply consistently with Departmental procedures.

3.29 HMRC suffers from inadequate Management Information Systems to help it risk-assess and control PAYE effectively. Numerous PAYE activities are taking place at any one time, but limited management information makes it difficult for HMRC to coordinate this work and promptly identify problems. The inadequacies include a lack of information on volumes, resourcing and costs of PAYE work.

3.30 Over a number of years, HMRC has given PAYE processing a lower priority than other areas of work. PAYE staff have been diverted to other areas where the Department considered additional resources were needed because the immediate risk was greater. For example, PAYE staff have been deployed periodically on tax credit work since it was introduced in 2003. This may have created a perception that HMRC regards PAYE as less important than other areas and affected both the amount of work which could be done and the quality of the work undertaken.

3.31 HMRC staff have not always been aware of or followed Departmental policies, for example, processing computer reports or in calculating tax code changes. HMRC's internal quality monitoring figures suggest that 7.9 per cent of all 2005-06 codes were incorrect. Error rates were higher where individuals had more complex tax affairs and in 2005-06 Internal Audit found that in 21 per cent of cases where individuals had more than one job, the correct code had not been identified and issued. Although some of the problems were caused by incomplete and inaccurate information from employers or individuals, HMRC also made errors in processing information.

3.32 HMRC staff have also found some departmental guidance to be contradictory and confusing resulting in different local practices. The PAYE system places heavy reliance on paper records such as error reports and returns from employers being correctly dealt with. But HMRC staff have not always processed these properly or performed the work in a timely manner.

Assessing the effect of the challenges in administering PAYE

3.33 In 2004-05 HMRC's Internal Audit began a programme of work to understand better the financial effect of these issues, which supplemented other HMRC initiatives to improve the quality of its PAYE work. The areas considered by Internal Audit include handling taxpayers with multiple incomes, checking tax paid on benefits in kind and using PAYE to collect tax identified under self-assessment.

Handling taxpayers with multiple incomes

3.34 Internal Audit examined a sample of records for employees with more than one source of income to assess whether the correct amount of tax was being collected in these cases. It concluded that in many cases HMRC is not correctly bringing together information on different sources of income and that incorrect amounts of tax are being paid. On the basis of results from a sample of cases, Internal Audit estimated that for 2003-04 potentially£275 million tax was overpaid and £490 million underpaid, affecting some 1.9 million taxpayers. Overpayments of tax arise where taxpayers do not get the benefit of all the personal allowances they should, for example when they change jobs and are not taxed on a cumulative basis across the year. Underpayments of tax may arise if taxpayers are allocated personal allowances at two different jobs, but HMRC does not bring together their total income and calculate their correct tax liability.

3.35 In June 2005, HMRC reminded staff of the need to consider all information received about second jobs to help identify and correct any overpayments and underpayments of tax. It has also made this work high priority for its staff in 2006-07. But computer changes are needed to fully resolve these problems and I discuss HMRC's plans to improve this area later in my report (paragraph 3.52).

Checking tax paid on Benefits in Kind

3.36 Employers who provide their employees with non-cash benefits, for example a company car, are required to report these benefits on an annual basis to HMRC by completing a form P11D. HMRC uses the information to adjust the employee's tax code in the next tax year to collect any tax due. HMRC received 5.6 million P11Ds in 2004-05, with a value of £9 billion in benefits provided.

3.37 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 so that the taxpayer pays the correct amount. Internal Audit reported in 2005-06 that the necessary clerical action is not always taken and computer printouts are not being worked accurately or in a timely manner, because of competing work priorities. Through a sampling exercise Internal Audit estimated that potentially this meant that £181 million tax was overpaid and some £519 million tax underpaid for 2003-04. These problems are thought to affect over 1.9 million taxpayers.

3.38 HMRC has examined how it can improve its performance in response to these findings. In January 2006, it reminded staff of the importance of handling promptly changes to tax codes and from April 2006, HMRC has given higher priority to this area of work. In April 2007 HMRC plans to introduce an automated process for managing changes to tax codes for Benefits in Kind. This should reduce the risk of the necessary changes not being processed by staff and reduce the number of cases that need to be reviewed after the year end. HMRC has also recently enhanced a computer tool provided to help staff calculate tax codes and use of the tool is now mandatory in all but the simplest cases.

Using PAYE to collect tax identified under Self Assessment

3.39 3.7 million PAYE taxpayers are also covered by the self assessment process. Final self assessment liabilities that are less than £2,000 can be settled through the PAYE system and HMRC amends tax codes to collect the amount due. There is no check in the automated process that the PAYE income is sufficient or that the adjustment to the tax code will collect the full amount due within 12 months, but HMRC is now considering how it could introduce such a check.

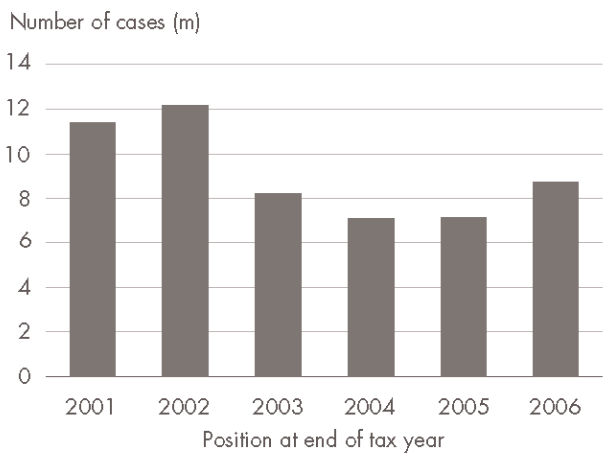
3.40 Internal Audit examined a sample of cases to check the accuracy of the changes in the codes to collect these liabilities. It calculated that in 2004/05 £36.5 million was lost because tax due was removed from the Self Assessment system but not processed through PAYE for collection. HMRC found that some of this was caused by problems when the interface between the self assessment and the PAYE computer systems was not working, which have now been resolved. Other failures were due to HMRC staff not following procedures to correctly update individual tax codes, and amounts due from taxpayers were not correctly processed through the PAYE system. HMRC's policy is that self assessment liabilities collected though PAYE should be settled in full in the year following that to which the charge relates. But its instructions to staff do not make this explicit and it did not happen in all cases, which delayed the recovery of £25.5 million tax. HMRC are reviewing this process with the aim of implementing changes by April 2007.

Managing levels of 'Open Cases'

3.41 At the year end, HMRC's computer system checks whether the tax an employee has 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, which are known as "open cases" and must be checked manually. HMRC may also have to wait some time before it has sufficient information to complete these checks, for example, when it does not have complete employment details. Based on the current number of PAYE records, HMRC expects about 12 million records would need manual checking as part of its normal PAYE business. But it is undertaking work to improve data quality and HMRC expects that this will increase the number of cases where it automatically matches employer returns against taxpayer records.

3.42 Between 2001-02 and 2004-05, HMRC operated a National Open Case Recovery Team to manage all aspects of open case recovery, including providing staff with better computer support, and the volume of open cases fell within this period. But volumes increased in 2005-06, as shown in **Figure 16** and there were 8.7 million cases outstanding at March 2006. The increase was caused partly by HMRC's difficulties in managing the online filing of employer returns (paragraph 3.14) which delayed the processing of returns and meant that open cases were identified later in the year than would normally be the case. There were also 2004-05 cases awaiting processing at the end of March 2006. HMRC expects that many of these will be cleared automatically when processed.

16 Numbers of open cases



Source: HMRC

3.43 HMRC estimates that three quarters of open cases arise from it not having full information on a taxpayer's employment history, failures by employers to provide the correct information or HMRC being unable to match information received to a National Insurance number. Complexities in an individual's tax affairs, such as multiple employments or frequent changes in work are more likely to mean a case needs manual review. Errors by HMRC staff have also contributed to open cases, for example failing to ask taxpayers for information where they have gaps in their employment history, failure to follow established procedures, and incorrectly estimating dates of starting and leaving work. In addition, HMRC has found that many taxpayers who are asked for further information needed to check whether they have overpaid tax simply do not reply.

3.44 In 2006, HMRC introduced a more rigorous process for validating end of year returns from employers who filed online. This increased the risk that more returns would be rejected and returned to employers, although overall the change should reduce the need for clerical action by HMRC staff and help improve the quality of incoming data. To reduce the adverse impact on employers, HMRC undertook a communications exercise with industry and individual employers and worked with software companies to improve the quality of data. HMRC's early findings suggest that failures to meet the quality standards have fallen from 13 percent in the first year to 5 per cent in returns filed online in April 2006.

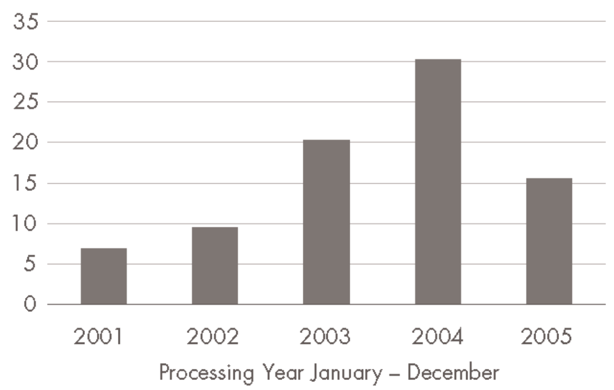
3.45 HMRC has also allocated additional resources to help reduce the backlog of open cases to a manageable level. It has recruited some 200 new staff to work on open cases and has also used staff in other areas to help it deal with the easier cases. HMRC has also offered overtime for its more experienced staff to handle the more difficult cases and it estimates that 2 million cases have been cleared this way. It is also taking steps to improve the quality of work undertaken on open cases, including introducing earlier and more frequent checks to identify errors and ensure they can be corrected more quickly. Internal Audit also plan work during 2006-07 to evaluate the end to end Open Case process and provide an assurance that procedures and guidance are being correctly followed.

3.46 Under the terms of an Extra Statutory Concession (ESC A19), HMRC staff are authorised to clear an outstanding open case by waiving any tax due, if the Department failed to act on information it held within a reasonable period and the taxpayer had reason to believe that their tax affairs were correct. The amount of tax waived has grown considerably during the last few years due to the drive to reduce the backlogs of open cases and peaked in 2004 at some £30.3 million. **Figure 17** shows the amounts waived over the last 5 years.

3.47 Internal Audit found cases where HMRC staff did not properly record details of tax waived and some that were cleared inappropriately. Internal Audit believed that a culture might have developed where staff considered it acceptable and normal for cases to be closed without following the correct process and obtaining proper authorisation.

3.48 In 2005, HMRC improved its instructions to staff on the procedures to be followed. As shown in Figure 17, the amounts of tax waived in 2005 were reduced significantly. HMRC expects this downward trend to continue in future years.

17 Tax waived or remitted 2001-2005 £million



Source: HMRC

Action being taken by HMRC to improve the PAYE process

3.49 In addition to the specific responses to the issues identified above, HMRC is looking at how it can improve the PAYE process generally. In May 2005, it established a PAYE Steering Group, which is responsible for identifying improvements across the entire PAYE process and implementing recommendations made by Internal Audit. The Group has overseen a series of "health checks" and risk assessments and HMRC has now identified important areas where the PAYE process can be improved. In June 2005 it put in place an Action Plan to manage its future work in achieving these improvements, although it will take a number of years before these changes are fully effective.

Making better use of information on taxpayers

3.50 Many of the problems with the PAYE process are caused by HMRC not having, or bringing together, a full picture of the tax affairs of individual employees. It is initially tackling this issue by making better use of the information it already holds and, in the future, expects its project 'Modernising PAYE Process for Customers' (MPPC) to result in significant improvements.

3.51 HMRC holds information on individual taxpayers on its computer systems for PAYE and National Insurance. The PAYE computer system is organised around employments, whereas the National Insurance system is organised around employees. But these systems are not integrated and the National Insurance system holds information that would help HMRC obtain a fuller picture of individual taxpayers.

3.52 The current phase of MPPC will be completed in September 2006 and is intended to provide PAYE staff with access to taxpayers' information held on the National Insurance system. This should provide PAYE staff with full details of an employee's employment history and make it easier to check if the right amount of tax has been paid. HMRC believes its initial findings from a trial project are encouraging. It also plans to move to its National Insurance computer system as the basis for administering the PAYE process, which will allow information on individuals to be brought together by reference to their National Insurance number, provide a complete view of an employee's income and enable that single view to be maintained effectively. Successful implementation should reduce significantly the major sources of errors, but HMRC consider the scale of the migration to a different system and its technical challenges mean that the computer changes are unlikely to be made before 2008-09.

3.53 The MPPC programme is designed to result in wider improvements in management information over the next two years. In addition, HMRC plan to introduce a modern work management system, to enable managers to direct priority work to appropriately skilled staff.

Better compliance with procedures

3.54 HMRC has to ensure that its staff fully comply with its procedures as well as making better use of the information it holds. It has therefore impressed on operational managers that staff must follow existing instructions. It is also looking at how it can introduce a more risk based approach to managing its work, to allow it to assign resources to those cases that have higher amounts of tax at risk. HMRC is introducing new processes in its offices, which include real time checks on quality and has introduced monthly quality monitoring checks to allow managers to target areas which need improvement. HMRC considers that these have resulted in fewer errors being made.

3.55 HMRC has set up a programme to help its processing operations meet the challenge of delivering a better experience for the taxpayer, whilst also achieving the efficiency savings required by the Gershon and Lyons reviews. One element includes a review of existing PAYE (and other) processes from the taxpayer's perspective with the aim of eliminating waste, duplication and inconsistency. Another important element is intended to support a more robust and visible approach to managing HMRC's work. It is still early in the life of the programme but HMRC believe initial results are promising with improvements in key performance indicators including turnaround time, quality and productivity.

Conclusions

3.56 In 2005-06 HMRC collected £114 billion income tax through PAYE from some 41 million employment and pension sources operated by 1.9 million employer or pension schemes. HMRC 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.

3.57 The PAYE computer system was introduced in the 1980s and its records are structured around employments, rather than individual taxpayers. As a result, HMRC can have difficulty in ensuring that taxpayers with more than one source of income pay the correct amount of tax because it may not know about additional sources of income.

3.58 To operate PAYE effectively, HMRC depends on employers and employees providing it with accurate and timely information on income and changes in employment. This does not always happen and can lead to the risk that taxpayers do not pay the right amount of tax. For example, HMRC estimates that for about 70 per cent of job changes employees do not immediately provide their new employer with the form P45, giving details of previous earnings and tax. And employers do not always update tax codes despite being instructed to do so.

3.59 The difficulties in the operation of PAYE have been compounded by inconsistent working practices within HMRC. Staff have not always been aware of or followed Departmental policies, for example adjusting tax codes to reflect Benefits in Kind. Deficiencies in management information have also made it difficult for HMRC to prevent or detect errors made by staff. And several times in recent years HMRC has diverted PAYE resources to other areas of work which it considered had higher operational priority, such as tax credits.

3.60 Over the last eighteen months HMRC has produced new information to provide a better picture of the scale of these problems and the amount of tax at stake. Based on a sampling exercise, its Internal Audit Office estimates that each year HMRC may not be pursuing some £1 billion of tax due, taxpayers may have overpaid around £500 million and consequently that 5.7 million taxpayers may not be paying the right amount of tax. These figures suggest an overall net under collection of tax revenue of some 0.5 per cent of the £114 billion collected through PAYE in 2005-06.

3.61 HMRC has responded by reminding staff of the importance of following procedures, improving its internal quality monitoring procedures and has introduced a programme to deliver a better experience for the taxpayer. It has also allocated additional resources to PAYE work. Whilst it believes these changes should reduce the level of errors, it recognises that real improvement requires fundamental changes. Accordingly, HMRC plans to improve its internal processes as part of its 'Modernisation of PAYE Processes for Customers (MPPC)' project. This project should also provide a complete view of an employee's tax affairs by making better use of the information HMRC already holds. Successful implementation should reduce a major source of error but HMRC considers the computer changes cannot be achieved before 2008 because of the technical challenges. HMRC has developed a series of responses to manage the risks in the interim period, but it needs to articulate these more clearly into an overall strategy.

3.62 Effective operation of PAYE also depends on employers and employees meeting their obligations and changing internal processes and systems will not address all the problems. HMRC needs to target and take further action to improve compliance by employers and employees who do not meet their obligations.

3.63 HMRC first recognised the emerging difficulties in administering PAYE in 2001-02, when it launched a recovery programme to clear the increasing number of open cases. But it has only recently begun to quantify the effect of these difficulties on the collection of tax. This quantification, coupled with HMRC's new organisational structure, has provided additional impetus to tackle these difficulties through a programme of short, medium and longer term improvements. In taking forward these improvements, and as new systems are developed, HMRC must ensure that it has appropriate management information to monitor the effectiveness of its procedures in collecting tax. Within its new framework for managing PAYE, HMRC also needs to have appropriate arrangements for monitoring emerging trends in the labour market to allow it to develop an appropriately planned response to future changes in the taxpayer population.

VAT: MISSING TRADER FRAUD

Scope of report

4.1 Missing trader fraud is one of the most serious attacks on the tax system ever seen. This report provides a background to the fraud and examines how HMRC is tackling the problem.

Background

4.2 Missing trader fraud is a systematic attack by organised criminal groups on the European Union VAT system. HMRC estimates that missing trader fraud cost the Exchequer between £1.12 billion and £1.90 billion during 2004-05 **(Figure 18)**. Operational indicators show that the level of activity related to the fraud has increased in 2005-06. HMRC attributes the rise in activity to the increased confidence of fraudsters following legal challenges to key measures. HMRC does not yet have all the data required to produce an estimate of VAT losses from missing trader fraud for 2005-06 and expects, in line with its own established practice, to publish this estimate alongside the 2006 Pre Budget Report later this year.

18 Estimated tax loss of missing trader fraud

Financial Year	Lower Estimate (£bn)	Upper Estimate (£bn)
1999-00	1.17	2.29
2000-01	1.31	2.47
2001-02	1.72	2.53
2002-03	1.54	2.34
2003-04	1.06	1.73
2004-05	1.12	1.90

Source: HMRC

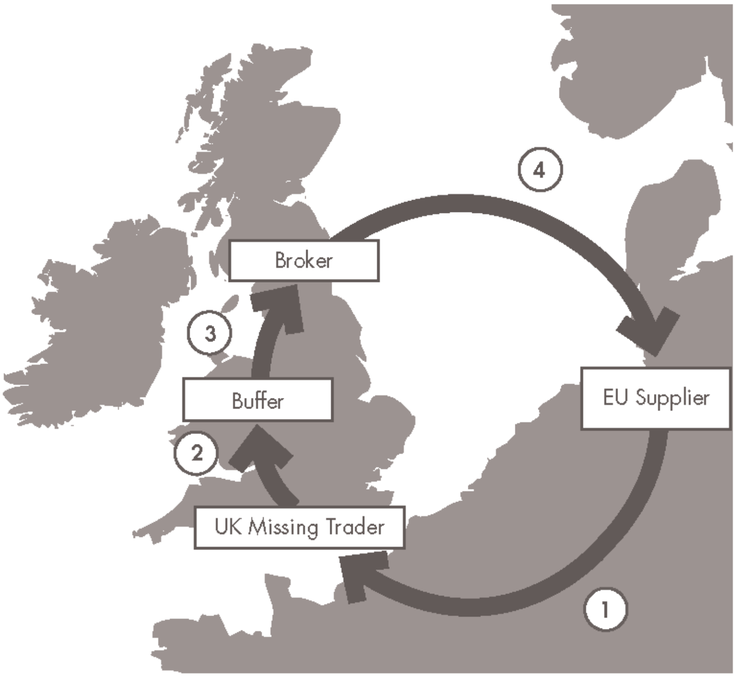
4.3 Fraudsters exploit the current VAT arrangements which were introduced in 1993 as part of the Single Market. The arrangements allow registered traders to acquire goods from traders in other Member States without paying VAT. This system was designed to ensure that VAT was accounted for and paid in the Member State where the goods were finally consumed. In its simplest form the fraud involves a business obtaining a VAT registration number in the UK for the purpose of purchasing goods free of VAT from another Member State. The business sells these goods at a VAT inclusive price in the UK and then disappears without paying the VAT to HMRC. In its most abusive form, commonly referred to as carousel fraud, fraudsters sell the same goods repeatedly through contrived supply chains involving traders in the UK and other Member States of the European Union. Fraudsters extract the VAT on each circuit, as illustrated in **Figure 19**. The most commonly-used goods in missing trader frauds are mobile phones and computer chips, but any high value compact goods are suitable.

4.4 Fraudsters have changed their methods in response to measures adopted by HMRC. Instead of going missing, fraudsters now continue to trade to generate greater tax losses before defaulting on payment of VAT. Fraudulent supply chains have also become more complex involving more buffer companies and the sale of goods between several chains in different Member States **(Figure 20)**. In addition, during 2005 HMRC noted an increase in chains exporting goods to third countries outside the European Union with which, until recently, there were no arrangements to exchange information. Goods, invoices and money may also follow different trails, creating further problems for HMRC to identify and prosecute criminals behind the fraud.

4.5 Missing trader fraud affects other European Union Member States, including Germany, Denmark and the Netherlands. In Denmark and the Netherlands fraudsters often sell goods as part of an apparently legitimate link in a larger chain and the tax is stolen in other Member States, such as the UK. The VAT loss in both these countries is comparatively low: Denmark estimates it at €134 million (approximately £92 million) between 1994 and 2005; and the Netherlands estimates an annual loss of €25 million (approximately £17 million). Germany, like the UK, is a target for the fraudsters. Although Germany has no formal estimate of missing trader fraud, it recognises that it is a significant problem. Unfortunately, the European Commission has no detailed figures on the total amount of missing trader fraud within the European Union. This is mainly because, unlike the UK, very few Member States estimate the level of the fraud. To have a clearer picture of the nature and extent of VAT fraud, the Commission is to examine different methods to assess fraud, estimate the total amount of VAT fraud across the European Union and gather comparable data for all Member States[12].

12 Memo 60/221, Commission of the European Communities, 31 May 2006.

19 An example of a basic 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.

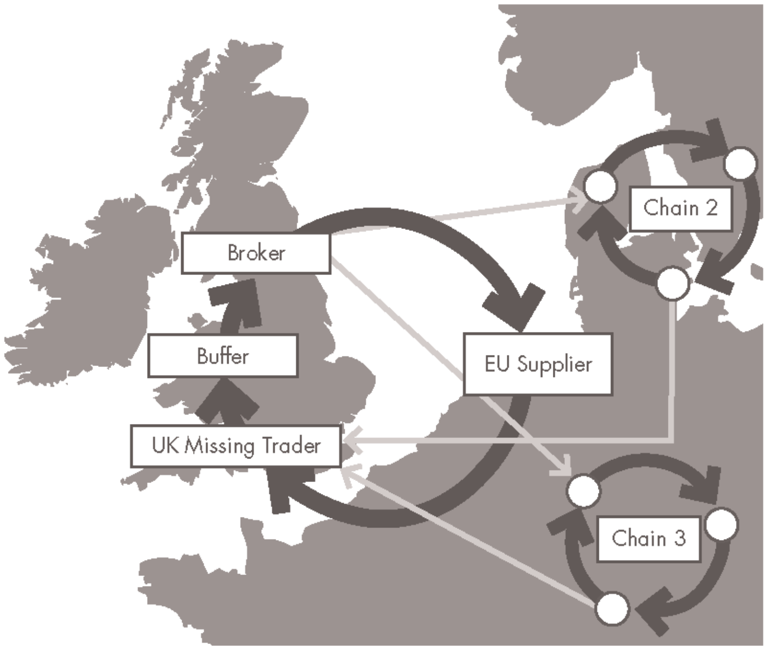
2. The trader sells the goods to another trader commonly known as the buffer at a reduced price of £900,000 plus £157,500 VAT. In order to avoid the price of the goods spiralling upwards each time the carousel turns, one business in the chain must sell at a loss. Following an intensive period of trading 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

20 An example of a complex chain



In response to efforts by tax authorities, fraudsters have begun more complex chains involving greater numbers of buffers and sales of goods between several different chains. Brokers may split consignments and sell goods through a series of chains in other Member States before goods return to the UK.

In one case identified by HMRC, a trader had supplied goods to over 200 different missing trader chains. HMRC requires assistance from other Member States to verify transaction chains.

Source: National Audit Office

4.6 In the European Commission's view, the introduction of a VAT system based on the origin of the supply of goods would remove the opportunity for the current type of missing trader fraud. Under this system VAT would be charged on all transactions between Member States, which would eliminate traders acquiring goods free of VAT. The Commission has found little support among Member States for the wholesale reform of the VAT system along these lines, as such a regime would demand a greater degree of tax harmonisation than currently exists to avoid the new system being burdensome for traders. In addition there would have to be a system of VAT allocation from the country of origin to the country of destination. HMRC's view is that an origin system would open up major new fraud opportunities. The current arrangements, which were only meant to be in place until the 31 December 1996, have therefore continued in the absence of an agreement on a definitive system.

4.7 In June 2000, the Commission launched a five year programme to improve the operation of the present system and in 2004 it published a review of the use of administrative cooperation to tackle VAT fraud[13]. It welcomed the fact that Member States had either introduced or were in the process of introducing legislative measures to protect the VAT system against missing trader fraud. It also concluded that, before making any modification to the VAT system, Member States should continue efforts to tackle fraud under the current system by working to improve administrative cooperation and national VAT control regimes. The UK and other Member States have therefore developed their strategies within the existing VAT framework.

4.8 On 31 May 2006 the European Commission adopted a Communication[14], the aim being to launch a debate with all parties concerned on a European Strategy to combat tax fraud. Although the proposal covers direct and indirect taxes, the fight against missing trader fraud is deemed a major issue. The Communication sets out a number of issues for discussion including: reinforcing cooperation between Member States; increasing cooperation with third countries; and the need to modify the current community VAT legislation.

HMRC's strategic response

4.9 In September 2000 a national strategy was launched to tackle missing trader fraud. It aimed to minimise VAT losses by preventing the fraud, detecting and disrupting fraudulent transaction chains, prosecuting fraudsters where appropriate and using civil measures to recover debts. For these activities to be effective, cooperation with other Member States, third countries and the legitimate trade is essential. HMRC has updated the strategy on a number of occasions and sought to introduce new legislation in response to changes in the fraud. Missing trader fraud is currently HMRC's top VAT fraud priority with around 1,000 staff deployed to tackle it.

Previous NAO and Parliamentary Scrutiny

4.10 On the basis of a report by the NAO, the Committee of Public Accounts took evidence from HM Customs and Excise in June 2004 on its activities to tackle VAT fraud[15]. On missing trader fraud the Committee recommended[16]:

- updating estimates of fraud to assess progress on a regular basis;
- adoption of legislation to allow best use of information and data sharing between the direct and indirect tax areas in HMRC;
- working closely with the European Commission to achieve prompt exchange with other Member States of information on traders; and
- working with the business community and professional bodies to agree criteria for reporting of misconduct by professionals.

4.11 HMRC's response to missing trader fraud has addressed the Committee's recommendations by:

- revising the methodology for estimating the level of the fraud to provide a more accurate figure;
- establishing mechanisms to help facilitate the sharing of information between the direct and indirect tax areas of the organisation;
- continuing to work closely with the European Commission and other Member States to improve the mechanisms for sharing information and joint detection exercises to tackle the fraud; and
- working with the tax and accountancy professions to develop guidelines to raise awareness of missing trader fraud.

13 Report from the Commission to the Council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud, April 2004.
14 Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee concerning the need to develop a coordinated strategy to improve the fight against fiscal fraud, May 2006.
15 Tackling VAT Fraud, NAO, HC 357, March 2004.
16 Tackling VAT Fraud, Report from the Committee of Public Accounts, HC 512, June 2004.

Measures to tackle missing trader fraud

4.12 HMRC recognises that different measures or a combination of measures may be required to tackle the different participants in the fraud. **Figure 21** illustrates the range of interventions that HMRC deploys to tackle suspected traders in fraudulent supply chains. In 2000 a national strategy was launched to tackle missing trader fraud, creating a centralised team to coordinate the gathering and dissemination of intelligence on traders. The use of a centralised approach has been very successful in the Netherlands, where the level of estimated fraud has fallen significantly from €250 million per year (£173 million) in the early 1990s to €25 million (£17 million) in 2005-06. HMRC has also introduced new integrated systems and shareable databases which have been of great benefit in enhancing the quality of intelligence and identifying those traders involved in the fraud.

21 HMRC has a range of measures to tackle suspected fraudulent traders

	HMRC Action	Measure
Trader begins business and applies for VAT registration number	Checks and risk assessments prior to registration	Application rejected Registration granted Registered with conditions Security requested
Trader defaults or goes missing owing VAT to HMRC	■ HMRC monitors activity of suspect traders and performs visits to check nature of activity ■ Intelligence gathering and investigation for prosecutions ■ Accounting period brought to an end and debt established ■ Use of asset recovery tools where debts owed to HMRC ■ Cooperation with other tax authorities to gather evidence	Deregistration Provisional liquidation Enhanced civil recovery Criminal prosecution
Contrived trading by buffers and brokers generates VAT repayment claims	■ HMRC monitors activity of buffers and brokers ■ Suspect repayment claims verified ■ Goods inspected and recorded	Joint and several liability for unpaid VAT Incorrect, unsubstantiated or abusive VAT repayment claim denied Criminal investigation and prosecution Traders placed on quarterly returns

Source: National Audit Office

Measures to prevent 'missing traders' from registering for VAT

4.13 A key part of HMRC's strategy for tackling missing trader fraud is to deny fraudsters the registration without which the fraud cannot be perpetrated. During 2005-06 HMRC received 284,804 applications for VAT registrations. The majority of applications are from businesses that wish to trade lawfully. For these HMRC has performance targets in processing applications that it aspires to meet, but it must also protect VAT revenue. HMRC reviews all applications to confirm the validity and accuracy of the information submitted. Registration units seek to identify potential fraudsters through a combination of data-matching exercises and risk assessments. High risk cases are referred to intelligence teams for further checks and HMRC may also visit traders during this period to verify the legitimate nature of their activity.

4.14 During 2005-06 3,629 cases were referred to the intelligence teams (**Figure 22**). Although the number of such referrals has fallen since 2004-05, the number of suspect applications refused by both the intelligence teams and the registration units has increased to 2,271 (1,484 by registration sites; 787 after further checks by intelligence teams) compared to 1,866 in 2004-05. The significant rise in the refusals by the registration sites in 2005-06 compared to 680 in 2004-05 is attributed to the introduction of risk advisors in each registration unit, coupled with revised parameters to ensure only the highest risk cases are referred for more detailed checking by intelligence teams. In addition, where HMRC believes tax revenue may be at risk, it can request financial security against future tax losses or impose other conditions such as the shortening of the first VAT period to make an early assessment of compliance. During 2005-06 there were 645 cases where registration was granted with conditions. The registration units also deregistered 387 traders involved in the fraud that had been identified.

4.15 In response to changes in the nature of the fraud HMRC developed new guidance for registration teams. Additional risk checks and registration procedures were introduced to identify fraudsters who try to bypass initial registration checks by acquiring control of a VAT registered company and applying to HMRC to amend their details to reflect the new business activity. HMRC monitors these requests to identify suspect activity which may indicate the occurrence of fraud.

22 Outcomes of registration checks

	2002-03	2003-04	2004-05	2005-06
Total number of applications for VAT registration	257,139	299,043	269,515	284,804
Number of referrals for detailed check	7,416	9,545	4,573	3,629
Number of suspect applications refused	914	929	1,866	2,271

Source: HMRC

Activities to monitor and disrupt suspected fraudulent chains

4.16 HMRC's non-criminal compliance work consists of a series of activities: visits to traders prior to registration to check their entitlement for a VAT number; identification and deregistration of missing and defaulting traders; monitoring activity of suspected buffers and brokers; verification checks of suspect VAT repayment claims; inspections of goods; and requests for financial security where there is evidence that VAT may be at risk. Previously these checks were implemented by compliance staff within the Regional Business Services structure. This had caused difficulties when requesting visits to traders as there was no central liaison point. In December 2005 HMRC transferred the 230 non-criminal compliance officers, who at that time dealt with missing trader fraud, to a central team to tackle compliance issues. The new structure enables national deployment of resources as well as central direction and coordination of day-to-day activity and a more flexible use of resources. This helps HMRC tackle the national risk of missing trader fraud in a more effective manner.

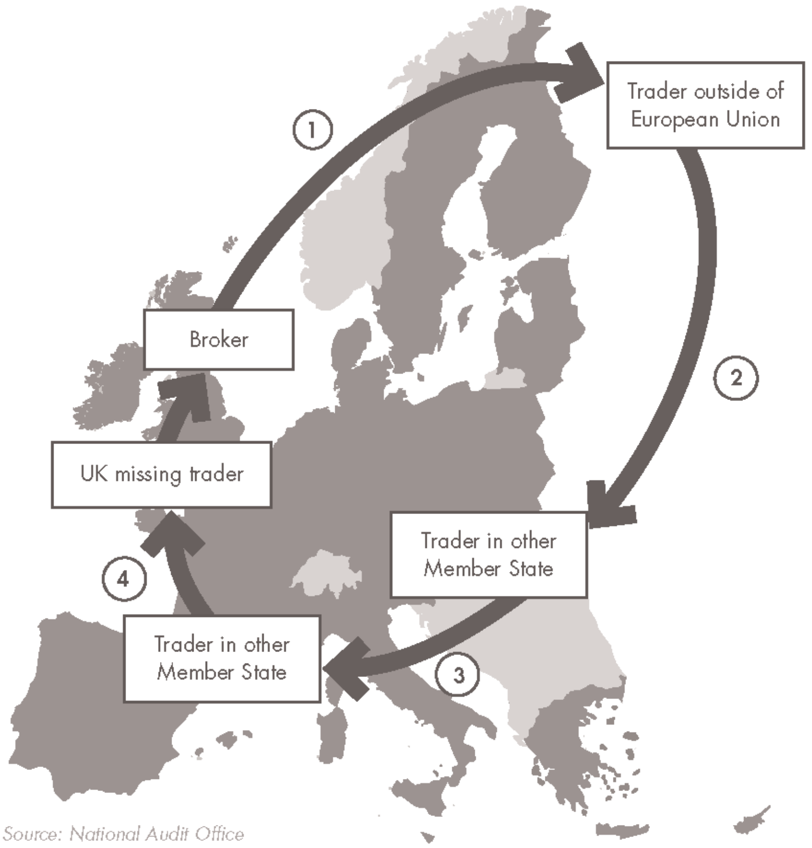
4.17 Under the VAT Act 1994[17], HMRC may request traders to provide a financial security to cover the estimated value of tax that may be at risk. The security may be a payment to HMRC or a guarantee from a financial institution, which must be provided to enable the trader to continue to trade lawfully. The use of security has proved to be a successful disruption technique. HMRC requested security from 74 registered companies between April 2004 and February 2006 and 18 of these either ceased to trade or were deregistered.

17 VAT Act 1994 paragraph 4(2) of Schedule 11.

4.18 To reinforce the effectiveness of this measure, Budget 2003 introduced the concept of extended security. This allowed HMRC to issue a warning letter to a company purchasing from a trader involved in the fraud, advising that the company would be required to provide security if it continued to purchase from this supplier. HMRC issued 126 warning letters to traders up to December 2005 and most of them stopped trading with the respective supplier. When companies did not respond HMRC required them to provide a financial security which it did on seven occasions. The measure was challenged and the High Court referred the case to the European Court of Justice, which ruled, in May 2006, that it was not in line with the European VAT legislation (4.38).

4.19 During 2005 HMRC identified a change in the trading patterns of suspect traders noticing a substantial rise in UK exports of mobile phones to third countries outside of the European Union. HMRC believes that this is a direct response to greater cooperation between Member States to successfully disrupt the fraud within the European Union. The diversion of goods through a third country makes it more difficult for HMRC to obtain evidence of the trail and prove the contrived nature of the supply chain (**Figure 23**). HMRC believed that the underlying economic and commercial trends did not support such an increase regarding two of these countries. Therefore, it began to check and document exports to both countries of mobile phones. Checks were performed concurrently at different UK ports, reconciling export documents to the actual volume of goods, date-stamping packaging and scanning of unique identification numbers and barcodes on goods. In December 2005 exports of mobile phones to both countries fell significantly. HMRC attributed this to the deterrent effect of the exercises (partially at least in cooperation with the relevant Customs Authorities) and the likelihood that the original increase did not represent real sales. It also noted the diversion of goods through other countries. The exercises have provided valuable operational knowledge and the opportunity to pilot scanning equipment. During one exercise HMRC scanned 272,000 mobile phones, of which 36,000 (13 per cent) had previously been stamped in the UK proving the circular sale of the goods.

23 An illustrative example of a missing trader chain through a third country outside the European Union



1. The broker at the end of the UK chain exports to a third country outside the European Union and is entitled to repayment of input VAT from HMRC. Fraudsters typically export to third countries with low duties on imports or free trade zones.

2. Within a few hours, the fraudsters transport the goods back to the European Union with final destination stated as the UK. On entering the European Union, import duties are deferred under Community Transit rules until goods reach the final country of destination.

3. Consignments may be split and sold through a number of traders in different Member States to mask the true identity of the goods.

4. Goods emerge as intra-community supplies, which are sold free of VAT to the UK missing trader. The chain can then begin again.

Key:

European Union Countries

Non-European Union Countries

Source: National Audit Office

4.20 Following the success of the scanning exercises HMRC introduced a new electronic scanning database in January 2006 and equipped teams at major UK ports with scanning equipment. Teams are able to scan the unique identification number of phones or any goods with a barcode and download the information to the database. This allows HMRC to identify traders who participate in fraudulent chains and to follow the movement of goods within UK ports. This information may be shared with other Member States to aid their respective controls over VAT. HMRC plans to allocate an additional 40 to 60 staff in 2006-07 to deal with missing trader checks on exports.

4.21 Within the European Union, HMRC seeks mutual assistance to gather trading information from other Member States. However, with third countries, HMRC is dependent on the content of agreements of administrative or legal assistance and has sought to address this by establishing bilateral agreements or memoranda of understanding to facilitate the exchange of information. Other Member States have also experienced similar problems with goods normally associated with the fraud: Denmark has seen a significant increase in both exports and imports of mobile phones and computer chips to and from third countries, whereas the Netherlands has observed an increase in third country imports, most of which the NAO was informed, were destined for the UK. The Commission recognises that missing trader fraud transcends the external borders of the European Union, and in its Communication in May 2006 outlined a Community approach to cooperation with third countries.

4.22 HMRC has also worked closely with Switzerland within the framework of an agreement in the form of an exchange of letters between the European Community and Swiss Confederation. This builds on the Agreement between the European Community and the Swiss Confederation on mutual administrative assistance in customs matters[18] signed on 9 June 1997. This has enabled HMRC to ask the Swiss authorities to visit freight forwarders in Switzerland to help identify companies involved in a number of carousel chains operating in the UK. Member States are currently reviewing the 'Cooperation Agreement between the European Community and its Member States (EU Commission) and the Swiss Confederation to Combat Fraud'. The UK ratified the agreement on 14 February 2006[19]. Although Switzerland has signed the agreement, it has not yet been ratified by the Swiss Parliament. Once ratified HMRC will be able to request information on traders and individuals including details of banking operations by those involved in the fraud[20]. This could provide evidence to bring cases against companies trading through Switzerland as part of the fraudulent chain, or identify assets of those individuals holding monies outside of the UK.

4.23 In October 2005 HMRC also established a compliance pilot project to review the use of direct taxes to tackle those participating in the fraud. The aim is to assess whether fraudsters declare total earnings on which corporation tax, national insurance contributions or income tax may be due. The new measures include a risk intelligence team to facilitate the exchange of information between the direct tax and indirect tax areas of the organisation. This is a welcome development in line with recommendations made by the Committee of Public Accounts in 2004[21].

Investigating fraudsters

4.24 HMRC is responsible for investigating criminal cases of revenue fraud[22] and providing evidence to the Revenue and Customs Prosecutions Office, which is an independent government department responsible for the prosecution of major drug-trafficking and tax fraud cases in the UK. Criminal cases are complex as a result of the sophistication of the fraud and it may take a number of years to complete investigations and prosecutions. As at December 2005 HMRC was investigating 70 missing trader fraud cases, of which 38 cases started before April 2003; all of which HMRC expects to reach trial before 2008. During 2005-06 HMRC began 16 new cases, which provide valuable insight into the way the fraud is changing and HMRC can use this intelligence to allocate resources to areas of risk. Up to March 2006, HMRC had secured 111 convictions in missing trader fraud cases resulting in jail sentences of 342 years and just under £60 million worth of confiscation orders made. **Figure 24** summarises a successful case brought against fraudsters in August 2005.

18 The term 'customs matters' means the laws and regulations enforced by the Customs Administrations concerning the importation, exportation, and transit or circulation of goods as they relate to customs duties, charges, and other taxes or to prohibitions, restrictions, and other similar controls respecting the movement of controlled items across national boundaries.
19 Statutory Instrument 2006 No. 307 The European Communities Order 2006.
20 Proposal for a Council Decision on the conclusion of the Agreement between the European Community and its Member States and the Swiss Confederation to combat fraud and any other illegal activity to the detriment of their financial interests, Article 32.
21 Tackling VAT Fraud, Report from the Committee of Public Accounts, HC 512, June 2004.
22 Revenue fraud includes fraud relating to taxes, duties and National Insurance contributions.

24 Successful prosecution results in 22 years jail for fraudsters

In August 2005, four people were found guilty of their part in a carousel fraud worth an estimated £40 million over a two year period. The fraud involved setting up twelve fictitious companies in the UK which were clones of legitimate UK companies dealing in mobile phones. The cloned companies sold consignments of goods to UK traders and issued fraudulent invoices using the names and VAT registration details of the legitimate UK businesses. The fraudsters requested payments be made to bank accounts in Hong Kong, where the funds could be dispersed and the VAT on the sales was never paid over to HMRC. In September 2005 the individuals were sentenced to a total of 22 years in jail.

Source: HMRC

4.25 During the course of an investigation and prosecution, HMRC may suspend the collection of VAT assessments in selected instances until the outcome of the trial process, so as not to jeopardise the cases. These debts are pursued at the earliest opportunity after the conclusion of the proceedings. Where there are successful prosecutions, confiscation of assets is always pursued to cover established debts. At March 2006 the level of missing trader fraud suspended debt was £702 million. A significant proportion of this debt will not be recoverable for some time and may ultimately have to be written off if there are few assets to liquidate.

4.26 During 2005-06 HMRC employed 212 dedicated missing trader fraud full time equivalent investigators. In addition it allocated another 200 full time equivalent staff to investigate missing trader fraud cases from VAT and Criminal Finance Investigations. An additional 48 individual staff were recruited during the year to the dedicated missing trader team. Financial resources for the additional staff were approved in April 2005, but complications in the recruitment process meant that they were not appointed until January 2006. They are expected to be fully operational by 2007 following completion of an accredited investigations qualification. The staff resources allocated reflects the recognition of the growing problem of missing trader fraud during the year.

4.27 The Serious Organised Crime Agency was established in April 2006[23] with the statutory responsibility of preventing and detecting serious organised crime. However, the responsibility for the investigation of revenue fraud has remained with HMRC. The two organisations have signed a memorandum of understanding detailing their responsibilities and identifying potential areas for collaboration, such as joint working and sharing of intelligence. During 2005-06, approximately 711 full time equivalent staff transferred from HMRC's investigations teams to the Agency[24]. HMRC considers that this has not delayed the completion and commencement of existing and new missing trader cases respectively, given that most of the transferred staff were primarily involved in drug investigations.

Recovery of VAT in missing trader cases

4.28 HMRC faces considerable challenges to recover debts owed by missing traders who cannot be located and defaulting traders who have insufficient assets to cover the debts. HMRC can invoke provisional liquidation where significant levels of VAT are owed and the company refuses or is unable to pay the debt. HMRC provides evidence that the company is unable to pay its debts and presents a petition to court to wind up the company. The court may authorise the freezing of the company's assets and appoint a liquidator to sell them to cover the debts. In furtherance of this action HMRC asks the Court to examine the evidence regarding transactions with other companies that led to the defaulter not being able to pay the VAT and to freeze the accounts of those companies. It also assists the liquidator in recovery action.

4.29 Provisional liquidation immediately stops the trader's activity and therefore prevents further tax losses. During 2004 and 2005 HMRC initiated 38 provisional liquidation cases. NAO reviewed 12 of these with total VAT debts of £91.6 million. HMRC had recovered a total of £4.1 million from the liquidators in relation to these cases by March 2006 and expected to receive a further £3.9 million. Of the 12 cases only one had been completed and in many others there were limited or no assets to recover. However, HMRC's action had prevented further tax losses. One of the companies had accumulated a VAT debt of £6.4 million in just four weeks of trading.

23 The Serious Organised Crime Agency takes over the functions of the National Crime Squad, the National Criminal Intelligence Service, the role of HMRC in investigating drug trafficking and related criminal finance and some of the functions of the UK Immigration Service in dealing with organised immigration crime.

24 The figure of 1,127 staff transferring to SOCA shown in HMRC's 2005-06 Annual Report includes both investigations and intelligence staff.

4.30 HMRC may also use other civil measures to recover debts such as a creditor's liquidation. But this option may take between six to eight weeks longer and the fraudster may continue to trade and accumulate further VAT losses. HMRC has estimated a future revenue benefit of £48 million for the 12 cases examined based on the potential tax loss in a six week period. An additional benefit of taking provisional liquidation action is that it freezes the bank accounts of the company and allows HMRC to gather further intelligence which may be used to identify and disrupt other fraudulent companies that may be involved in the supply chain.

Cooperation with other Member States, the tax and accountancy professions and the trade

4.31 The exchange of information between Member States is a key tool in combating missing trader fraud within the European Union. The Council regulation on administrative cooperation allows Member States to exchange information with another member that may help to effect a correct assessment of VAT[25]. The regulation sets a deadline of 90 days for the response to a request for information. During 2004 HMRC received 854 requests and responded to 449 (53 per cent) within the deadline. In September 2004 it set up a designated coordination team to speed up the time taken to respond to these requests. However, there has only been a slight improvement in responses in 2005: HMRC received 664 requests and provided responses to 367 (55 per cent) within the required deadline during the period.

4.32 The Council regulation also allows Member States to provide information on a particular trader in another Member State through a 'spontaneous' exchange. However, there is no requirement to inform the sending Member State of the benefit of the information supplied. By February 2006 HMRC had received 2,066 exchanges of spontaneous information, 214 of them from the Danish Tax Authority. The Tax Authority told the NAO that they suspected some Danish companies were involved in supply chains with missing traders in the UK. However, there was no tax loss in Denmark and therefore only limited criminal investigations could be undertaken. The Tax Authority added that if formal feedback procedures were adopted, it could use this information to undertake further investigation of Danish companies that persistently participated in fraudulent chains.

4.33 The current regulation on mutual assistance does not provide for formal feedback on the quality of information exchanged other than at annual meetings of Member States. HMRC plans to review a sample of exchanges from April 2006 in conjunction with another Member State to identify ways in which the exchange of information could be improved. Key findings will be developed further in conjunction with other Member States. The Commission has recently stated that mutual cooperation is one of the areas where it would like to see further improvements, and included it in its Communication, published on 31 May 2006, for further debate on a European Strategy to combat tax fraud.

4.34 The VAT Information Exchange System (VIES) is a computerised system that allows users to check information about VAT registered traders and the value of their sales to traders in other Member States. Traders are required to submit records of their transactions every three months. The system was introduced in 1993 following the abolition of border controls. It was originally a temporary measure to allow tax authorities to check the value of a trader's sales to other Member States and to make enquiries where necessary and issue VAT assessments where appropriate. There are difficulties in using trader information on the system since the data is at least three months old and traders may not record their transactions. In 2004, the Committee of Public Accounts recommended that HM Customs and Excise work closely with the European Commission to improve the system[26]. The Commission has put forward proposals which, subject to implementation by Member States, will improve the collection and quality of data, enhance the current VIES functionality, and provide more efficient tools to fight intra-community fraud. HMRC is currently providing assistance to the Commission during the development phase of the new system.

4.35 HMRC has also worked with the tax and accountancy professionals to raise awareness of the fraud. In December 2005, Deloitte, PricewaterhouseCoopers, KPMG and Ernst & Young published a joint statement to assist with HMRC's approach to tackling missing trader fraud. They stated that they would provide guidance to those clients who may be at risk from dealing with traders in missing trader chains and remind their staff of the requirement under the Proceeds of Crime Act 2002 and Money Laundering Regulations 2003 to report any suspicions of fraudulent activity. During 2006 several other accountancy firms have followed with similar statements. In addition, a number of professional bodies,

25 Council Regulation No 1798/2003 an administrative cooperation in the field of value added tax.
26 Tackling VAT Fraud, Report from the Committee of Public Accounts, HC 512, June 2004.

including the Institute of Chartered Accountants in England and Wales and the Chartered Institute of Taxation, have also expressed their willingness to cooperate with HMRC to tackle missing trader fraud. In March 2006, HMRC held a workshop with members of the Joint VAT Consultative Committee[27]. The objective was to discuss further ways to tackle missing trader fraud, create a shared understanding of the key issues and discuss guidelines for legitimate businesses and tax practitioners. These guidelines cover areas such as hallmarks to identify suspect activity and details on how to report this to HMRC. In addition, mechanisms for reporting the misconduct of members to the relevant professional body are currently being formalised by HMRC.

4.36 HMRC has worked closely with manufacturers from the key sectors affected by carousel fraud. Intel, a major manufacturer of computer chips, has provided training to HMRC teams to detect counterfeit chips and loaned scanning equipment to check whether goods had been involved in previous missing trader chains. Furthermore, HMRC has sought expert witnesses to provide statements in cases against fraudsters in respect of the commodities used to perpetrate the fraud.

Legal developments

4.37 In January 2006 the European Court of Justice upheld a challenge to HMRC's use of the 'non-economic activity argument'. VAT repayments were withheld to companies on the grounds that they were part of an overall chain to defraud and that the circular sales of goods in the chains had no economic substance. The Court ruled that the measure was inconsistent with the European Union Sixth VAT Directive and stated that the right to deduct VAT could not be affected by the fact that the transaction chain was vitiated by fraud. But, the Court's judgement also stated that where the trader knew or had means of knowledge that fraud has occurred[28], this may affect the right of the trader to deduct input tax. In light of this decision, HMRC has developed a series of checks which it is now using to tackle suspected traders.

4.38 In 2005 the Federation of Technological Industries challenged two measures introduced by HMRC in the Finance Act 2003, the joint and several liability and the extended security measure, arguing that there was no authority under European Legislation to impose them. The Court of Appeal referred the case to the European Court of Justice as the matter related to the interpretation of European Legislation and the Court gave its ruling in May 2006. HMRC has interpreted the ruling that the Sixth VAT Directive does provide that Member States may enact legislation to make one taxable person jointly and severally liable for the VAT debt. The Court states that such a measure could be applied if the individual had knowledge or reasonable grounds to suspect that VAT would go unpaid in the supply chain, provided that such a measure is proportional[29]. HMRC has accepted that the ruling on the extended security measure means that it cannot use this as widely as it has, although the measure may be used where traders are found jointly and severally liable for a debt. HMRC is reviewing this and other rulings by the European Court of Justice in VAT-related cases, to identify the ramifications of these judgements on tackling missing trader fraud in the UK.

4.39 In March 2006 the Government announced that it would introduce legislation to support HMRC in intensifying its operational activities. This included: making explicit HMRC's power to evidence the inspection of goods which will enable it to identify subsequent movements of goods and traders involved in fraudulent chains; and directing individual businesses to maintain relevant records, such as the unique identification numbers of mobile phones. In addition, the Government sought a derogation from the European Commission in December 2005 to permit the introduction of a 'reverse charge' for mobile phones, computer parts and related goods. The measure would effectively remove the VAT from the distribution chain from wholesaler to retailer but it would be invoiced at the end of the chain to the final customer. An example is detailed in **Figure 25**. There is a risk that there may be a diversion to goods not covered by the legislation or to other types of fraud. HMRC is aware of this potential risk and said that it will deploy existing operational tactics to deal with this problem if it becomes apparent that other goods are being used to perpetrate the fraud. However, it believes that there are only a limited number of goods to which it could mutate. HMRC will also need to undertake additional administrative checks on traders to ensure compliance with the new system.

27 The Joint VAT Consultative Committee is comprised of representatives from HMRC, accountancy and tax professional bodies and representatives from industry and finance.
28 Judgement made on 12 January 2006 in case of Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs and Excise.
29 Judgement made on 11 May 2006 in case of Commissioners of Customs and Excise, Attorney General v Federation of Technological Industries and others.

25 An illustrative example of how the reverse charge mechanism works

A trader in the UK buys goods for £100 from a trader in another Member State. The UK trader pays no VAT as sales of goods between registered companies in the European Union are zero- rated. Under the current system, the UK trader sells the goods for £200 plus £35 output VAT to a business customer. The UK trader pays £35 to HMRC and the business customer is able to reclaim £35 input VAT from HMRC. The UK trader could defraud HMRC by withholding the £35 output VAT.

Under the reverse charge, no VAT would be paid to the UK trader. Instead the business customer would buy the goods for £200 and self account for both the input and output VAT of £35. The net effect is that there is no VAT to reclaim from HMRC.

The effect of this mechanism is that VAT in the chain is not held as cash and therefore cannot be stolen. If the business customer sells to an individual, it charges VAT in the sale price and accounts for this in the normal way.

Source: National Audit Office

4.40 The Commission is required to reach a decision on the derogation before presenting a proposal to the Council of Ministers. The UK will be able to implement the proposed legislation if approved by the Council. Although the decision is not expected until late 2006 or early 2007, the Commission indicated in its recent Communication (May 2006) that it is prepared to consider extending the reverse charge mechanism to domestic transactions in a Member State. However, it stipulates that any change to the VAT system must considerably reduce the possibilities for fraud, exclude any opportunities for new types of fraud, generate no disproportionate administrative burden for companies and the authorities, achieve tax neutrality and ensure non-discriminatory treatment of operators.

4.41 Tax advisors had recommended the reverse charge mechanism in 2003 in evidence on the Finance Bill 2003 to the House of Lords Select Committee on Economic Affairs[30]. At the time HM Customs and Excise did not take up the recommendation, believing that the fraud may be pushed further up the supply chain and that the charge would require businesses to set up dual accounting systems for VAT in the sectors involved. The Finance Bill introduced other measures which, along with the practice of withholding VAT repayments where no economic activity could be shown, contributed to the continued reduction in losses in 2003-04. The Financial Statement and Budget Report 2006 sets out estimates of the expected tax yield from implementing the reverse charge system in future financial periods (**Figure 26**).

26 Expected additional tax yield on introduction of the reverse charge

2006-07 £m	2007-08 £m	2008-09 £m
100	500	425

Source: Financial Statement and Budget Report 2006, Her Majesty's Treasury

30 The Finance Bill 2003: Evidence – Volume II, Select Committee on Economic Affairs, House of Lords, 10 June 2003.

Conclusions

4.42 Missing trader fraud is one of the most serious attacks on the tax system ever seen. It is a systematic attack by organised criminal groups on the European Union VAT system. HMRC's strategy, launched in September 2000, reduced the losses: in 2003-04 the level of fraud fell for the second year running, to between £1.06 billion and £1.73 billion. However, 2004-05 saw an increase in losses of between £1.12 billion and £1.9 billion and the latest operational indicators suggest that the level of activity related to the fraud has increased. The organised criminals behind the fraud are very resourceful and have reacted quickly to measures implemented by HMRC, setting up sophisticated and contrived transaction chains to avoid detection. To address these latest developments, HMRC has further strengthened its operational activities and plans to introduce new legal measures to help tackle the fraud.

4.43 Tax practitioners recommended the introduction of a reverse charge mechanism to the tackle the fraud in evidence to the House of Lords Economic Affairs Committee in 2003. This measure would remove the VAT from the distribution chain from wholesaler to retailer, and thus reduce the possibility of this type of fraud occurring. Other measures introduced in 2003 have proved successful in reducing the level of fraud. However, in 2005 the confidence of the fraudsters and the level of fraud increased. The Government sought a derogation in December 2005 from the European Commission to permit the introduction of a reverse charge for goods normally associated with the fraud, such as mobile phones and computer chips. HMRC has estimated that, if approved, this measure will yield an additional £1 billion of VAT receipts over the next three years. There is, however, a risk that the fraudsters will divert to goods not covered by the legislation.

4.44 HMRC and other Member States, supported by the Commission, are working closely through administrative cooperation to tackle the fraud. However, fraudsters can obtain goods free of VAT and continue to perpetrate this type of fraud whilst the current arrangements in the VAT system remain. The Commission has considered an overhaul of the current VAT system, but due to a lack of consensus, Member States have not agreed a definitive system. HMRC should continue to lead work with the European Commission and other Member States to highlight the difficulties in tackling the fraud within the current legislative framework and to identify long term mechanisms through which tax authorities across the European Union may tackle the fraud.

4.45 Within the current VAT framework, improvements could be made to the quality and timeliness of information shared between Member States. Through the introduction of scanning databases in the UK and other Member States, there will also be opportunities to share greater detailed information to identify consignments of goods and traders involved in fraudulent chains. This information will therefore help HMRC to target its resources to tackle the fraud. The UK and some other Member States are now experiencing missing trader fraud that transcends the external borders of the European Union into third countries. The Commission has recently stated that it would like to see a community approach to cooperation with third countries. HMRC should use its experience and influence to facilitate these arrangements.

4.46 Several of the large accountancy firms and professional bodies have publicly supported HMRC's approach to tackle the fraud and sought to develop guidance for their clients and members who may come into contact with missing traders. HMRC should continue to work closely with these organisations to identify further measures that could be successfully introduced in the UK. Many of these organisations are also established or have affiliates across the European Union, and counterparts in these offices may have useful suggestions in tackling the fraud.

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