



House of Commons
Committee of Public Accounts

Corporation Tax: companies managed by HM Revenue and Customs' Area Offices

Forty-ninth Report of
Session 2005–06

*Report, together with formal minutes,
oral and written evidence*

*Ordered by The House of Commons
to be printed 12 June 2006*

HC 967
Published on 29 June 2006
by authority of the House of Commons
London: The Stationery Office Limited
£10.00

The Committee of Public Accounts

The Committee of Public Accounts is appointed by the House of Commons to examine “the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit” (Standing Order No 148).

Current membership

Mr Richard Bacon MP (*Conservative, South Norfolk*)
Annette Brooke MP (*Liberal Democrat, Mid Dorset and Poole North*)
Angela Browning MP (*Conservative, Tiverton and Honiton*)
Greg Clark MP (*Conservative, Tunbridge Wells*)
Rt Hon David Curry MP (*Conservative, Skipton and Ripon*)
Mr Ian Davidson MP (*Labour, Glasgow South West*)
Helen Goodman MP (*Labour, Bishop Auckland*)
Mr John Healey MP (*Labour, Wentworth*)
Mr Sadiq Khan MP (*Labour, Tooting*)
Mr Edward Leigh MP (*Conservative, Gainsborough*)
Sarah McCarthy-Fry MP (*Labour, Portsmouth North*)
Mr Austin Mitchell MP (*Labour, Great Grimsby*)
Dr John Pugh MP (*Liberal Democrat, Southport*)
Mr Don Touhig MP (*Labour, Islwyn*)
Kitty Ussher MP (*Labour, Burnley*)
Rt Hon Alan Williams MP (*Labour, Swansea West*)

The following were also Members of the committee during the period of the enquiry:

Mr Alistair Carmichael MP (*Liberal Democrat, Orkney and Shetland*)
Jon Trickett MP (*Labour, Hemsworth*)
Stephen Williams MP (*Liberal Democrat, Bristol West*)

Powers

Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at <http://www.parliament.uk/pac>. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Nick Wright (Clerk), Christine Randall (Committee Assistant), Emma Sawyer (Committee Assistant), Ronnie Jefferson (Secretary), and Luke Robinson (Media Officer).

Contacts

All correspondence should be addressed to the Clerk, Committee of Public Accounts, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5708; the Committee’s email address is pubaccom@parliament.uk.

Contents

Report	<i>Page</i>
Summary	3
Conclusions and recommendations	5
1 Tackling non-compliance	7
The tax at risk	7
The 'strike rate' of enquiries	8
The mix of full and aspect Corporation Tax enquiries	9
The balance of enquiry workloads	10
Penalties	10
2 Improving the performance of Areas	12
3 The administrative burden on companies	15
4 Electronic filing of returns	17
Formal minutes	18
Witnesses	19
List of written evidence	19

Summary

HM Revenue and Customs (the Department) collected around £33 billion in Corporation Tax in 2004–05, and expects receipts to increase to £42 billion in 2005–06. The Department's Large Business Service deals with the tax affairs of the largest businesses operating in the UK. Its network of 68 Areas deal with the rest – over a million companies – at a cost of around £220 million a year. These companies paid £15 billion in Corporation Tax in 2004–05.

Companies are liable for Corporation Tax on their profits, and are required to submit tax returns each year along with any tax due. Areas check the returns and undertake detailed enquiries on around 4% of returns. This work resulted in additional tax, interest and penalties of £602 million in 2004–05 where companies had not complied with their obligations. Since 1999, when Corporation Tax became a self-assessed tax, Areas have increased by 42% the extra tax yield they secure. Over the same period they have halved the number of enquiries, while making greater use of risk assessment techniques to guide their work.

The Department has no estimate of the overall tax at risk from company non-compliance. But its research indicates that around 40% of tax returns contain errors which if undetected would result in a tax loss. Yet only 60% of Areas' enquiries produce additional revenue.

The performance of Areas on enquiries varies markedly: in 2004–05 the coverage ranged from 2% of returns to 9%; the yield secured in some Areas was five times more than in others, differences not explained by economic factors; and some Area costs were two or three times more than others to secure similar yields. A major reason for these differences was a significant mismatch of staff to workloads. There were also differences in the use of risk-assessment databases and risk-profiling projects to select cases for enquiry. The Department is planning to rationalise the network into fewer but larger Areas, providing the opportunity to improve the efficiency and effectiveness of its work on Corporation Tax and other taxes.

Enquiries take many months to complete, even those that produce no additional tax yield. The Department has piloted in one Area a new internet based system for sharing information with companies during enquiries, which has reduced the time taken to complete enquiries by 20%.

There is little research on the administrative burden on companies of Corporation Tax. The Department has however been mapping the requirements of this and other business taxes to set a baseline for tracking and reducing the costs of compliance and it has now set a target for reducing the burden. The complexity of the tax is a particular concern to companies and appears to contribute to the level of errors in tax returns. The Department's consultations with the business community have led to some reforms to the structure of the Tax but cost or lack of consensus have impeded other proposals.

Electronic filing of Corporation Tax returns should bring a number of benefits. It would be more convenient for many companies. It should reduce the Department's costs and errors from keying-in data; and facilitate better risk assessment by enabling the Department to

analyse electronically a greater volume of data from returns. But so far only 2% of companies have filed their returns electronically. The Department expects to increase take-up by introducing a new system in summer 2006. Following Lord Carter of Cole's review of on-line services, the Department has decided that all companies will be required to file their returns electronically from 2010.

Conclusions and recommendations

- 1. In spite of a 40% error rate in returns, Areas conduct enquiries on only 4% of returns.** Yet only 60% of these enquiries succeeded in increasing the tax or profit assessment. The Department needs to improve the targeting of enquiries, and thereby increase the tax yield. It should strengthen the use of risk assessment techniques, particularly in those Areas which do not make full use of available databases and those with the lowest enquiry success rate.
- 2. 70% of the additional revenue secured from the Department's random enquiries was attributable to 5% of the companies examined.** The Department should use its random enquiry programme to identify the types of company which are most likely to be guilty of serious abuse and those that are making genuine errors. It should use the results to focus enquiry work on areas of greater risk and target education campaigns on companies that need help in understanding their obligations.
- 3. 'Aspect' enquiries achieve a pay-back four times better than 'full' enquiries because they are much less costly, but a higher proportion achieve no additional tax yield.** Most of the enquiries the Department undertake are 'aspect' enquiries, which focus on one or more feature of the tax assessment, but it also undertakes 'full' enquiries which examine the entire business. To improve the pay-back from its enquiry work, the Department should identify those types of enquiries which achieve no additional tax yield.
- 4. The Department decides the mix of Areas' full and aspect enquiries, and of Corporation Tax and other tax enquiries, but without a full understanding of their relative marginal effectiveness.** It is developing a risk strategy for its compliance work, looking across business taxes. It should establish the marginal pay-back of the different elements of that work to focus on areas of greatest potential return. It should also set a target to increase the current level of 9% of Corporation Tax full enquiries that also cover other taxes.
- 5. The Department imposed penalties for negligently inaccurate returns in half of the full enquiries which produced additional tax yield in 2004–05, but it applied penalties in only 5% of aspect enquiries.** Aspect enquiries often involve questions of interpretation of accounting and tax rules. To show whether Areas are applying penalties consistently and effectively, the Department should analyse the types of cases that are penalised and those that are not, and the scale of abatements applied.
- 6. Over the last five years, the Department has referred only five agents or advisers to their professional bodies for breach of professional ethics or conduct.** Despite assurances to our predecessors in 2004, there appears to be little progress in increasing the number of referrals. As part of its current 'modernising powers, deterrents and safeguards' review, the Department should include proposals for dealing more effectively with non-compliance that results from poor professional advice.
- 7. The wide variations in Areas' enquiry coverage, results and efficiency indicate scope for higher yields and cost savings. If all Areas had achieved the national**

average in 2004–05, yields could have been £60 to £100 million more. The Department is using the National Audit Office's benchmarking analysis to develop its management of Area performance. In so doing, it should track Areas' relative efficiency in securing additional tax yield compared with the size of their local company caseload. It should also apply a similar approach in managing other locally-administered taxes.

8. **The variation in enquiry coverage – from 2% in some Areas to 9% in others – means that companies of a similar risk are more likely to be subject to an enquiry in some Areas than in others.** This uneven coverage stems from imbalances across Areas in the number and experience of staff compared with the size and complexity of the Areas' caseloads. The Department should reassign more work between Areas to even out coverage and workloads.
9. **Varying results and efficiency of enquiry work across Areas reflect this mismatch of resources to risk, and differences in risk assessment skills between Areas.** The Department's plans to restructure the local office network provide an opportunity to address these factors. In a new network structure, the Department should provide offices of sufficient size to achieve efficient processing and enquiry work, applying the full range of risk-assessment skills. It should also redesign its compliance work to match the risks posed by different business sectors.
10. **The Department's shared work-space project has shown promising results in speeding up enquiries, which often last for a year or more.** Subject to the successful extension of the project to London offices during 2006, the Department should extend it to all local offices thereafter. It should also extend to all offices its new system of team working where staff specialise in specific enquiry tasks. The aim should be to achieve at least the 20% reduction in the time taken to complete enquiries that has been achieved in the shared work-space pilot Area.
11. **Electronic filing offers many benefits for the Department and companies, but only 2% of companies are filing their Corporation Tax returns on-line.** The Department aims to introduce by Summer 2006 a system for companies to submit their accounts, as well as their returns, in a form that feeds directly into the Department's computers. It plans to require all companies to file their returns on-line by 2010. The Department has a corresponding responsibility to make the new system reliable and easy to use, so that companies are not forced into a process which imposes substantial costs on them.

1 Tackling non-compliance

1. HM Revenue and Customs collected £33 billion in Corporation Tax in 2004–05, and expects to collect around £42 billion in 2005–06. The tax is charged on the profits of companies resident or conducting business in the United Kingdom. Taxable profits are derived from accounting profits after a range of adjustments and allowances.¹

2. The Department manages Corporation Tax payers in two groups. A Large Business Service deals with the largest 900 groups of companies, who paid £18 billion in Corporation Tax in 2004–05. A network of 68 Areas deals with the 1.1 million returns from other companies, who paid £15 billion in 2004–05. This Corporation Tax work cost £220 million, or 1.4 pence per pound of revenue. Each Area is responsible for processing and checking the tax returns of its local companies. Areas assess the returns for possible risks of non-compliance and select some cases for more detailed enquiries.²

The tax at risk

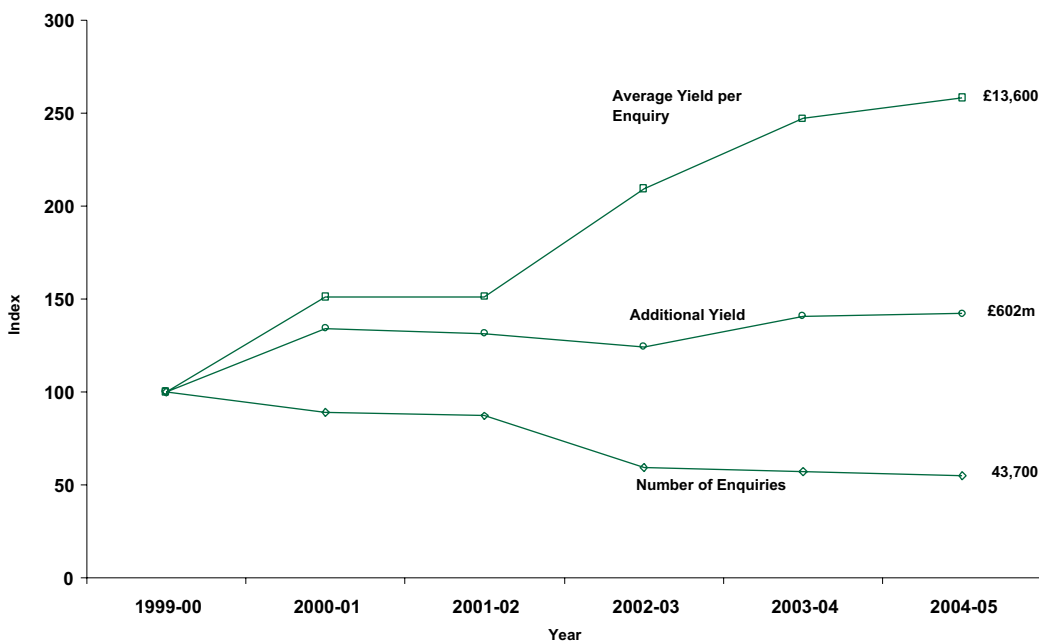
3. Since 1999–2000, when self-assessment was introduced for Corporation Tax, the Department has reduced the number of Area enquiries by almost half. But it has improved its targeting of higher risk returns and thereby, as **Figure 1** shows, has increased the additional tax generated by these enquiries by 42% in real terms. Areas generated £602 million in additional yield (tax, interest and penalties) from the 43,700 enquiries completed in 2004–05.³

1 C&AG's Report, *Corporation Tax: companies managed by HM Revenue and Customs' Area Offices* (HC 678, Session 2005–06), para 1.1; Q 31; *Budget 2006* (HC 968, Session 2005–06), Table C8

2 C&AG's Report, paras 1.5, 2.1

3 *ibid*, para 2.7 and Figure 3; Qq 3, 18

Figure 1: Relative trends in the number of enquiries and the additional tax yields they achieved, in real terms (indexed-values; 1999–2000 = 100)



Source: C&AG's Report, Figure 3

Note: Additional yields and average yields are in real (2004–05) terms, derived from Treasury GDP deflators.

4. The effectiveness of enquiries in tackling non-compliance, however, must be viewed in the context of the 'tax gap' – the difference between the total tax that is theoretically payable and what is actually paid. Assessing the tax gap from macro-economic data is inherently difficult. The Department conducts a random enquiry programme to provide intelligence on the level of error in tax returns resulting in the under-payment of tax and the nature of non-compliance risks.⁴

5. The Department does not yet have sufficient data to draw robust conclusions on the likely amount of tax being lost overall, but results to date indicate that 40% of returns have errors that would result in underpayment of tax. The size of these errors varies greatly and can result from misunderstandings or carelessness on the part of companies, or from serious abuse. 5% of companies examined accounted for 70% of the underpaid tax. The Department uses the results to direct its enquiries to the areas of risk.⁵

The 'strike rate' of enquiries

6. Overall, Areas conduct enquiries on 4% of returns. The Department focuses its enquiries on those companies which it considers most likely to produce additional tax. Yet only 60% of enquiries produce a change in the tax or profit assessment. The annual cost of enquiries which produce no change in the tax or profit assessment is £9 million. The Department

4 C&AG's Report, para 2.11; Qq 21, 37, 44

5 Qq 2, 49, 71, 83, 85, 87, 105; Ev 14–15

regards it as inevitable that some enquiries will not produce additional tax, but it does not set a target for an acceptable “success” rate for its enquiries.⁶

7. The number and cost of enquiries producing no change suggest scope to improve the risk assessment of returns. The success of this process depends on the experience of tax inspectors and the skilled use of databases on companies’ affairs to inform the assessment. In recent years the Department has developed various databases and encouraged their greater use by Areas, as well as the use of risk-profiling ‘projects’. Following successful piloting, the Department is introducing a new database that brings together data previously held in different sources. It is also seeking to bring a more strategic focus in its use of risk assessment expertise, and is introducing a ‘team working’ approach to make better use of inspectors’ time by allocating tasks more closely to the level of staff experience needed.⁷

The mix of full and aspect Corporation Tax enquiries

8. Areas undertake a mix of ‘aspect’ and ‘full’ enquiries. Aspect enquiries examine the accuracy and tax treatment of one or more particular features of a return and tend to be used for larger, more complex companies. Full enquiries focus on the disclosure and accounting for the entire income and assets of a business and its owners, and tend to be used for smaller less complex companies. 81% of full enquiries secure additional Corporation Tax or a profit adjustment (**Figure 2**), and these include some random enquiries which are not risk-targeted. Aspect enquiries produce less yield on average and have a lower ‘strike rate’, with only 58% resulting in a change to the tax or profit assessment. Nevertheless, aspect enquiries have a better pay-back rate because they are much less costly than full enquiries.⁸

Figure 2: The results of ‘full’ and ‘aspect’ Corporation Tax enquiries, 2004–05⁹

	Full enquiries	Aspect enquiries	All enquiries
Number completed	4,500	39,200	43,700
Average yield	£26,700	£12,300	£13,800
Average staff cost	£5,600	£500	£1,100
Average yield:cost ratio	4.8 : 1	22.6 : 1	13.1 : 1
Proportion of enquiries resulting in a tax or profit adjustment	81%	58%	60%

9. To check a company’s tax position, the Department has to open a formal enquiry. In recent years, Areas have developed ‘enabling’ relationships with some of their larger local companies to discuss and resolve Corporation Tax issues, and companies may provide supporting records to the Department for review before they submit their returns. The

6 Qq 2–3

7 C&AG’s Report, paras 2.18, 4.9; Qq 8, 50, 109

8 Qq 3, 39

9 C&AG’s Report, paras 2.7–2.8, 4.4–4.5, Figure 5

advantage for the Department is that points of uncertainty can be resolved and compliance improved without the need for a formal enquiry. Such enabling work, however, accounted for only 1% of the time spent by Areas on Corporation Tax compliance work in 2004–05.¹⁰

The balance of enquiry workloads

10. In planning the number and mix of enquiries by Areas, the Department takes account of the number and grade-mix of Area staff and their company caseloads. It seeks to cover the spectrum of companies submitting returns – both large and small companies. The Department plans this coverage, however, without a detailed assessment of the relative compliance risk of different sizes of business, and without a clear view of what marginal changes in the enquiry mix might produce in terms of yield and cost.¹¹

11. With an underlying error rate in returns of 40%, it is likely that higher yields could be achieved if additional resources were deployed to increase the number of Corporation Tax enquiries. But whether a 4% level of coverage is appropriate depends not just on the marginal yields and costs of such work but also on wider considerations about the deployment of enquiry effort and resources across the different taxes, and the demands they place on business. The Department is developing a risk strategy for business taxes, to help it reassess its levels of enquiry coverage.¹²

12. The risks posed by a particular company for Corporation Tax may also be indicative of its risk on other taxes, for example VAT, PAYE and Income Tax. Some of the more common errors found in Corporation Tax returns may also affect the personal tax affairs of the directors. 9% of Corporation Tax full enquiries also covered other taxes in 2004–05.¹³

Penalties

13. Penalties for negligently inaccurate returns, geared to the tax at stake, can discourage non-compliance. Of the 19,000 enquiries which produced an increased tax assessment, only 13% were penalised. Legislation allows the Department to impose penalties of up to 100% of the additional tax payable but, as with other taxes, it applies abatements for voluntary disclosure of errors, the seriousness of the offence and the co-operation the company gives the Department in the enquiry. The Department does not record centrally the types of cases that are penalised and those which are not, or the scale of the abatements applied, to assess whether penalties are being used effectively to deter non-compliant behaviour. Without such analysis, it is also unable to show that it applies penalties equitably across Areas and for companies of different size and type.¹⁴

14. The Department applies fewer penalties on aspect enquiries than full enquiries. It imposed penalties in half of the full enquiries where it identified an additional tax liability, compared with only 5% in aspect cases. In imposing penalties, the Department has to establish that the return is incorrect and understates the tax due, and that the error arises

10 C&AG's Report, para 3.7; Qq 3, 71

11 C&AG's Report, paras 2.15, 2.20; Q 16

12 Qq 16–17

13 C&AG's Report, paras 2.24–2.25; Qq 26, 45

14 C&AG's Report, paras 2.9–2.10; Q 94

from the negligence of the company. Aspect enquiries often involve questions of interpretation of accounting and tax rules. If a company makes an error having relied in good faith on external professional advice, the Department cannot apply a penalty.¹⁵

15. If the Department considers that advisers and agents are in breach of their professional ethics, it can refer them to their professional bodies. But it has done so only five times in the last five years. Yet in response to our predecessor Committee's Report on Tackling VAT fraud in 2004, HM Customs and Excise, having previously referred only four cases, had expected to increase the numbers reported to professional bodies.¹⁶

16. The Department can impose a penalty if companies do not provide information it requests for its enquiry. But the Department acknowledges that a rate of £30 a day is only a minor inconvenience for many companies.¹⁷

15 Q 80

16 Q 99; Ev 14–15; 36th Report from the Committee of Public Accounts, *Tackling VAT fraud* (HC 512, Session 2003–04), para 23 and conclusions and recommendations para 7; Treasury Minute, Cm 6304, September 2004, paras 15–17

17 Q 82

2 Improving the performance of Areas

17. There are significant variations between Areas in the coverage, results and costs of enquiry work. On average 4% of returns are subject to enquiry, but this ranges from 2% to 9% across Areas so that companies of a similar size and complexity are more likely to be subject to an enquiry in some Areas than in others. The average yield from enquiries in some Areas was five times higher than in others – a difference not explained by economic factors. The proportion of enquiries resulting in a tax or profit adjustment ranged from 44% in one Area to 80% in another. Similarly, average enquiry costs were two to three times higher in some Areas than in others, which was not simply the result of economies of scale in Areas with larger caseloads or the complexity of the task.¹⁸

18. These variations in the coverage and results of enquiries indicate scope for higher tax yields and improvements in efficiency. For example, if Areas with below average enquiry yields could have secured the national average, the total yield could have been £60 to £100 million more in 2004–05, and more still if all Areas could have matched the best performing Areas.¹⁹

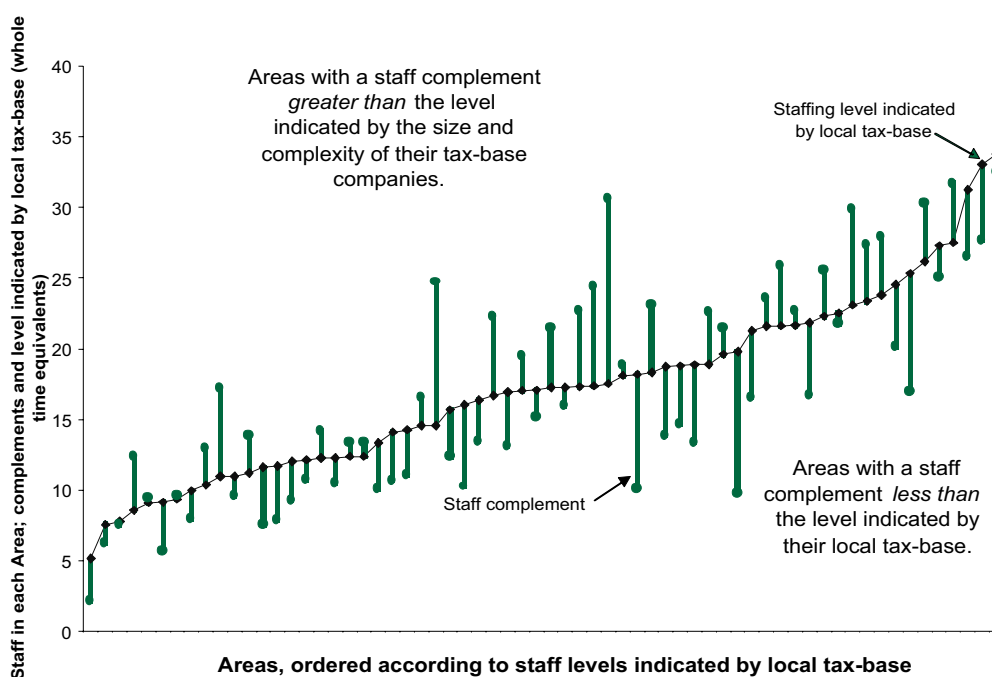
19. This variation in performance stems from a mismatch between the numbers of staff and skills deployed on Corporation Tax work in the 68 Areas and the distribution of the company caseload. It also reflects the small size of some Areas: the largest having 33 Corporation Tax staff, but some only five. A third of Areas had a target number of enquiries which was more than 25% higher or lower than the number warranted by their company tax-base (**Figure 3**). Areas have also adopted different risk assessment practices, with some making greater use of more sophisticated techniques and databases.²⁰

18 C&AG's Report, paras 2.13–2.14, 4.4

19 *ibid*, para 2.23

20 *ibid*, para 2.15; Qq 13, 28

Figure 3: Corporation Tax enquiry staff in Areas – comparison between complement and staffing levels indicated by the Areas' company caseload (2004–05)²¹



20. The Department acknowledges the need to improve performance. It intends to introduce the type of benchmarking analysis in the C&AG's Report to drive up performance in Areas to the standard of the better-performing Areas. It is also introducing new resource planning information systems to identify more accurately the work done by staff.²²

21. To address variations in workload and even out inconsistent coverage, some Areas have made informal arrangements to redistribute their workloads. The Department expects to address the more deep-seated causes of performance variation through a more fundamental restructuring of the network, as it rationalises the operations of the newly merged Department. It intends to restructure the network into fewer, larger offices. The restructuring will need to take account of all work carried out by local offices, of which Corporation Tax work, involving 2,000 out of the 39,000 staff, is only part. Any transition to a new structure would need to recognise that the work depends on a cadre of professionally trained staff with many years of experience, and that new staff could not easily be recruited locally to fill posts.²³

22. On Corporation Tax work, the Department is moving towards a nationally-based assessment of risks. Rationalising into fewer offices would allow greater specialisation in risk assessment techniques and also in compliance work on particular business sectors.

²¹ C&AG's Report, Figure 7

²² Qq 28, 78

²³ C&AG's Report, para 2.16; Qq 14–15

While a local presence enables staff to acquire knowledge of their local companies and agents, only 5% of the Areas' work involves visiting businesses.²⁴

3 The administrative burden on companies

23. Complying with their Corporation Tax obligations places a burden on companies. This includes keeping up to date with legislation and ensuring their tax return is complete and accurate. There is little research on the costs companies incur although some other business taxes present a heavier burden for taxpayers. The Department has been mapping the requirements of Corporation Tax and other business tax processes to set a baseline for tracking and reducing the costs of compliance. As a result of that work, the Department has recently set a target to reduce the administrative burden of dealing with the Department on the various taxes by 10% over a five year period.²⁵

24. Business and tax representative bodies have identified the complexity of Corporation Tax as a concern, particularly the computation of taxable profit. The Government launched a programme of Corporation Tax reform August 2002, which has effectively now run its course. This resulted in some simplification, for example by removing an artificial distinction between trading and investment companies. Other proposed changes have not been implemented, however, either because they lacked the support of business or because of the likely cost to the Exchequer.²⁶

25. One such example was the proposal to reform the ‘schedular system’. This adds complexity by requiring companies to differentiate sources of income for tax purposes. It also results in companies being unable to set losses from one source against profits from another. To contain the cost, the Government proposed a partial revision of the system. This was rejected by the business community, who had favoured abolition, because they felt that the benefits of partial reform would not justify the compliance cost associated with any change.²⁷

26. Companies selected for enquiry face the additional burden of providing additional information and dealing with the Department during the enquiry. The Department does not know the cost of enquiries for the companies, but it incurs average costs of around £1,100 per enquiry. In March 2006, the Department announced that to help reduce the burden on companies it would consult on a range of possible new ‘compliance interventions’, which would be more flexible than the existing enquiry system. Since 2002–03 it has reduced the time enquiries take, but full enquiries still take on average over two years to complete, and aspect enquiries over a year. Even when full enquiries do not result in a change to the tax or profit assessment, they take 71 weeks on average. That average masks a range in Area averages from 23 weeks to 115 weeks.²⁸

27. The Department has recently piloted an internet-based ‘shared electronic work-space’ system for managing enquiries, which has reduced enquiry times by 20% in one Area. This new approach enables Area staff and company agents to share analysis and update

25 Q 45; *Progress towards a new relationship: how HMRC is working to make life easier for business*, HM Revenue and Customs, March 2006, para 12

26 C&AG’s Report, para 3.14; *Progress towards a new relationship: how HMRC is working to make life easier for business*, HM Revenue and Customs, March 2006, para 2.7

27 C&AG’s Report, para 3.14; Q 10

28 C&AG’s Report, para 2.16, 3.10, 3.12, Figure 10; *Progress towards a new relationship: how HMRC is working to make life easier for business*, HM Revenue and Customs, March 2006, para 2.30

common records, making it easier for companies to provide additional information that is requested. This reduced the time that agents take in dealing with requests for information and the duplication by staff of the work of agents. The Department is extending the system to ten Areas in London from April 2006.²⁹

4 Electronic filing of returns

28. Following the merger of its two predecessor departments, HM Revenue and Customs faces a significant challenge in linking its IT systems and bringing them up to date, including the facility to file tax returns on-line. Electronic filing of returns should offer a number of benefits. As well as convenience for companies, it should reduce the Department's costs and errors by eliminating the need to key-in data from paper returns. It could also improve the Department's risk assessment of tax returns, by allowing the transfer to its risk databases of more data from the return and the supporting company accounts, than is possible with paper returns.³⁰

29. Until recently the accounts and documents supporting the return could only be submitted electronically as 'pdf' format documents, and only 2% of companies have taken advantage of the on-line filing facility. Larger companies, with more complex financial accounts, have not used the system in its current state of development.³¹

30. Since February 2006 the Department has provided a system to allow companies to submit their accounts and computations in their own format. It has also been developing the system to allow them to submit their accounts in a format which can also be read by the Department's computers. To do this, the system uses accounts software that electronically tags companies' accounts records using a common taxonomy which the Department has been developing with accounts software companies and other tax authorities. The Department expects that companies will be able to use the new system from Summer 2006.³²

31. In the United States, the Internal Revenue Service is making electronic filing mandatory for companies with net assets over \$10 million. The UK Government has also decided that all companies will be required to file their returns on-line using the new system from 2010, as recommended by Lord Carter of Coles in the *Review of HM Revenue and Customs Online Services*, published with *Budget 2006*.³³

32. Variation in the efficiency of processing returns between Areas suggests potential for savings. If, for example, all Areas were to increase their rate of processing to the national average, their processing costs might be reduced by 13%. The scope for savings is more significant, however, if on-line filing allowed processing to be centralised. The Department had foreseen a reduction of 30 posts, out of 800 processing staff, from the increase in electronic filing it envisaged without compulsion. The mandatory use of on-line filing would present opportunities for more significant rationalisation and savings.³⁴

30 Q 57

31 Qq 55–56, 58; Ev 14–15

32 Qq 57, 108

33 Q 113

34 C&AG's Report, paras 4.2–4.3; Q 20

Formal minutes

Monday 12 June 2006

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Annette Brooke
Greg Clark
Helen Goodman

Mr Sadiq Khan
Mr Austin Mitchell
Kitty Ussher
Mr Alan Williams

A draft Report (Corporation Tax: companies managed by HM Revenue and Customs' Area Offices), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 32 read and agreed to.

Summary read and agreed to.

Conclusions and recommendations read and agreed to.

Resolved, That the Report be the Forty-ninth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned until Wednesday 14 June at 3.30 pm.]

Witnesses

Wednesday 1 March 2006

Page

Sir David Varney KT, Mr Stephen Banyard, and Mr Douglas Tweddle CBE,
HM Revenue and Customs

Ev 1

List of written evidence

HM Revenue and Customs

Ev 14

List of Reports from the Committee of Public Accounts Session 2005–06

First Report	Managing National Lottery Distribution Fund balances	HC 408 (<i>Cm 6712</i>)
Second Report	The regeneration of the Millennium Dome and associated land	HC 409 (<i>Cm 6689</i>)
Third Report	Ministry of Defence: Major Projects Report 2004	HC 410 (<i>Cm 6712</i>)
Fourth Report	Fraud and error in benefit expenditure	HC 411 (<i>Cm 6728</i>)
Fifth Report	Inland Revenue: Tax Credits and deleted tax cases	HC 412 (<i>Cm 6689</i>)
Sixth Report	Department of Trade and Industry: Renewable energy	HC 413 (<i>Cm 6689</i>)
Seventh Report	The use of operating theatres in the Northern Ireland Health and Personal Social Services	HC 414 (<i>Cm 6699</i>)
Eighth Report	Navan Centre	HC 415 (<i>Cm 6699</i>)
Ninth Report	Foot and Mouth Disease: applying the lessons	HC 563 (<i>Cm 6728</i>)
Tenth Report	Jobskills	HC 564 (<i>Cm 6724</i>)
Eleventh Report	Local Management of Schools	HC 565 (<i>Cm 6724</i>)
Twelfth Report	Helping those in financial hardship: the running of the Social Fund	HC 601 (<i>Cm 6728</i>)
Thirteenth Report	The Office of the Deputy Prime Minister: Tackling homelessness	HC 653 (<i>Cm 6743</i>)
Fourteenth Report	Energywatch and Postwatch	HC 654 (<i>Cm 6743</i>)
Fifteenth Report	HM Customs and Excise Standard Report 2003–04	HC 695 (<i>Cm 6743</i>)
Sixteenth Report	Home Office: Reducing vehicle crime	HC 696 (<i>Cm 6743</i>)
Seventeenth Report	Achieving value for money in the delivery of public services	HC 742 (<i>Cm 6743</i>)
First Special Report	The BBC's investment in Freeview: The response of the BBC Governors to the Committee's Third Report of Session 2004–05	HC 750 (<i>N/A</i>)
Eighteenth Report	Department for Education and Skills: Improving school attendance in England	HC 789 (<i>Cm 6766</i>)
Nineteenth Report	Department of Health: Tackling cancer: improving the patient journey	HC 790 (<i>Cm 6766</i>)
Twentieth Report	The NHS Cancer Plan: a progress report	HC 791 (<i>Cm 6766</i>)
Twenty-first Report	Skills for Life: Improving adult literacy and numeracy	HC 792 (<i>Cm 6766</i>)
Twenty-second Report	Maintaining and improving Britain's railway stations	HC 535 (<i>Cm 6775</i>)
Twenty-third Report	Filing of income tax self assessment returns	HC 681 (<i>Cm 6775</i>)
Twenty-fourth Report	The BBC's White City 2 development	HC 652
Twenty-fifth Report	Securing strategic leadership in the learning and skills sector	HC 602 (<i>Cm 6775</i>)
Twenty-sixth Report	Assessing and reporting military readiness	HC 667 (<i>Cm 6775</i>)
Twenty-seventh Report	Lost in translation? Responding to the challenges of European law	HC 590 (<i>Cm 6775</i>)
Twenty-eighth Report	Extending access to learning through technology: Ufi and the learndirect service	HC 706 (<i>Cm 6775</i>)
Twenty-ninth Report	Excess Votes 2004–05	HC 916 (<i>N/A</i>)

Thirtieth Report	Excess Votes (Northern Ireland) 2004–05	HC 917 (<i>N/A</i>)
Thirty-first Report	Northern Ireland’s Waste Management Strategy	HC 741
Thirty-second Report	Working with the voluntary sector	HC 717 (<i>Cm 6789</i>)
Thirty-third Report	The Royal Parks and the Diana, Princess of Wales Memorial Fountain	HC 644 (<i>Cm 6789</i>)
Thirty-fourth Report	Returning failed asylum applicants	HC 620
Thirty-fifth Report	The refinancing of the Norfolk and Norwich PFI Hospital	HC 694
Thirty-sixth Report	Tackling the complexity of the benefits system	HC 765
Thirty-seventh Report	Inland Revenue Standard Report: New Tax Credits	HC 782
Thirty-eighth Report	Channel Tunnel Rail Link	HC 727
Thirty-ninth Report	Consular services to British nationals	HC 813
Fortieth Report	Environment Agency: Efficiency in water resource management	HC 749
Forty-first Report	The South Eastern Passenger Rail Franchise	HC 770
Forty-second Report	Enforcing competition in markets	HC 841
Forty-third Report	Delivery chain analysis for bus services in England	HC 851
Forty-fourth Report	National Offender Management Service: dealing with increased numbers in custody	HC 788
Forty-fifth Report	Employers’ perspectives on improving skills for employment	HC 862
Forty-sixth Report	Governance issues in the Department of Enterprise, Trade and Investment’s former Local Enterprise Development Unit	HC 918
Second Special Report	The BBC’s White City 2 development: The response of the BBC Governors to the Committee’s Twenty-fourth Report of Session 2005–06	HC 1139 (<i>N/A</i>)
Forty-seventh Report	NHS Local Improvement Finance Trusts	HC 562
Forty-eighth Report	HM Customs and Excise: Standard Report 2004–05	HC 874
Forty-ninth Report	Corporation Tax: companies managed by HM Revenue and Customs’ Area Offices	HC 967

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 1 March 2006

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Angela Browning
Greg Clark

Mr Ian Davidson
Mr Austin Mitchell
Kitty Ussher

Sir John Bourn KCB, Comptroller and Auditor General, National Audit Office, was in attendance.

Ms Paula Diggle, Treasury Officer of Accounts, HM Treasury, was in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

Corporation Tax: Companies Managed by HM Revenue and Customs' Area Offices (HC 678)

Witnesses: **Sir David Varney KT**, Executive Chairman, **Mr Stephen Banyard**, Director, Corporation Tax and VAT and **Mr Douglas Tweddle CBE**, Director, Local Compliance, HM Revenue and Customs, gave evidence.

Q1 Chairman: Good afternoon. This afternoon, we are dealing with the management by HM Revenue and Customs of Corporation Tax and we welcome back Sir David Varney. Do you want to introduce your team?

Sir David Varney: Thank you very much; it is nice to be back. On my right is Mr Stephen Banyard who is Director for CT and VAT and on my left is Doug Tweddle who is Director, Local Compliance and the Enforcement and Compliance Operations Unit.

Q2 Chairman: I want to deal with non-compliance to start with. If you look at paragraph six of the Executive Summary, you will see that areas concluded inquiries on 4% of active companies. Then later on, in paragraph nine, you will see "It has detected errors by companies in around 40% of company tax returns dealt with by Areas". Are you doing enough therefore Sir David to tackle non-compliance?

Sir David Varney: You have asked two questions put together so may I answer that with some statistics, trying to put the framework in which we operate, which might lay the background on which we might pursue the discussion this afternoon? Centrally we require the areas to put 10% of their effort into random inquiries. What that shows is how many companies, as a result of the effort, have to pay more tax. We, in doing that, come to see that there is only a small number of companies which are responsible for most of the additional tax that is produced. So we are looking at a situation in which, when we do the inquiry into the number of companies which are the subject of raising more tax, it is not the generality, it is a very small number and that has led us, therefore, to think about how we focus our efforts on finding the companies which have tax to pay. So the fact that 40% get them wrong, when you come to the value of how much is at stake, the

majority of the value is in a very small number of companies. What we need to do, given the scarce resources we have, is to focus on those companies which are likely to produce a yield, likely to produce a benefit for the tax system.

Q3 Chairman: Part of this inquiry is about the performance of the various areas. How they perform against each other and how they can be benchmarked against each other, so let us just look at that. If you look at paragraph seven of the Executive Summary—it is a bit confusing because once again we have this figure of 40%—“Nevertheless, across the network, 40% of all Corporation Tax enquiries produced no additional tax yield or taxable profit adjustment”. So that rather leads one to ask whether you are putting your effort in the right place.

Sir David Varney: Let me start by saying that this is against us halving the number of inquiries and increasing by 42% the yield we have got over the period since 1999 and 2000. So we are having more success. Like all statistics this statistic is right, but if you are going to use it for managerial purposes, you need to unpack it. We run two sorts of cases. We run full cases, which are detailed inquiries, and we run aspect inquiries. We have to open an inquiry if we are going to inquire of a corporation about their tax position. We ran 5,400 full inquiries and 38,900 aspect inquiries in the period under consideration. We are successful in raising CT, corporation tax, in 81% of the full cases and successful in 58% of the aspect cases. The aspect cases cost about £500 to mount; the full cases cost about £5,600. So the 40% is a blend figure of two different sorts of inquiries. What it tells you is that CT yield is not found primarily in the aspect cases, because they have a rate where in 42% we find no CT. We have gone back since the NAO Report to look at how much this has

 HM Revenue and Customs

cost us. It costs us about £9 million which means about 20% of the money that we spend goes into cases for which we get no CT yield. What we do find though in quite a few cases is that we might not get a CT yield, but will find, for example, that a director has under-Reported their income. So there may be a benefit. It is inevitable if you are targeting against risk that you are going to have an amount of money which is going to be spent on inquiries which do not produce an income. Then the question is whether that has a deterrence effect. As we say in the Report, one of the things we want to do is think about the impact of our inquiry process on the wider deterring.

Q4 Chairman: What I particularly want to ask you about is the different performance of areas; there is a large variation. Look at paragraph 12 of this summary. "There are also large variations across Areas in the additional tax yield . . . Overall, the average yield from full inquiries was £27,000, but ranged from an average of £13,000 in one Area to £60,000". How are you going to raise the game of these areas which are apparently not doing so well?

Sir David Varney: Let me say that we are going to raise the game and the Report is a help in that. May I direct your attention to the graph on page 31? I am sorry if this is going to turn into a commentary on statistics, but if we are going to use statistics, we need to understand the basis on which these numbers are put in. What we are dealing with are inquiries which take more than one year, so there is an element in the settlement where, if you have a very large settlement, it can have a disproportionate impact on where you are in the scatter diagram. For example, if you look at the dot which is above the £25,000 average yield, that is a result of 285 settlements. If you take the top two settlements out, the dot immediately drops down to the blue line. The point I am making is that a very small number of settlements have a big impact. We have put all the areas together to look at the differences between regions, because we primarily manage this centrally through a regional structure. What we find is that there is still a gradient. Is there an opportunity to improve? Yes, by sharing best practice, investing in better risk management, better data control. A one year snapshot does not do justice to a process which runs over more time, but it does indicate the need to improve performance and that is what we want.

Q5 Chairman: This is a one year snapshot with the NAO? Were you doing your own snapshots before the NAO came along?

Sir David Varney: No, this has been helpful.

Q6 Chairman: So why were you not doing it then?

Sir David Varney: Because we had newly established the delegation. We were concentrating on yield and taking comfort from the yield and fewer inquiries. This has produced what is a valuable input for us. We shall consider it.

Q7 Chairman: But you do accept this is one area where benchmarking does work in government. You can benchmark between different areas, you can

bring up the worst performing areas, you can promote people, demote people. It is something you should do more of perhaps?

Sir David Varney: I am sure you would like to do it on the basis of good statistics. What this does is make a case for management, which is the right role of the NAO, for us to go away and think about the management implications of this, to build the sort of performance management system which will deliver better performance.

Q8 Chairman: How will you change the way that these network managers do their business then?

Sir David Varney: We are investing in better techniques about risk assessment, which is covered to some extent in this Report. We are looking at different ways of working, trying to aggregate more skills together in central places, more team working and we have a programme which would transform the way we receive data, receiving it really in an electronic form, which would enable us to run better risk management than we run at the moment. Most of the data we get can arrive electronically, like it can come on a fax machine, but it is not set up in a framework which enables us to put it into analysis systems which can then identify risk.

Q9 Chairman: Why do inquiries take so long?

Sir David Varney: Some evidence has been given to the inquiry into medium-sized companies. First of all it is a question of whether it is a gaming arrangement, secondly whether it has the priority and thirdly, something we can do something about. As a way of conserving public funds we send replies by second-class mail and we have been investing in what is called shared electronic workspace, which we started in South Wales with a small number of agents where the data is common and held in a secure e-room. That is the shared working initiative which is partly covered in the Report. We are now looking to roll that out in April to 10 of the area offices in London and that has been a question of getting an enterprise licence and being able to do that in an affordable way. That reduces the time spent on the inquiries by about 20%.

Q10 Chairman: Lastly, in terms of simplifying it and making it easier for the business community, you and the business community have spent three years to try to work out how to simplify corporation tax and apparently very little of substance has emerged. Why is this? Why has so little been achieved?

Sir David Varney: First of all, as the Report shows, in terms of the compliance burden internationally the UK's is significantly lower than most other countries which are mentioned in the comparison, as is shown in figure nine on page 24 where the compliance costs are identified. Two proposals were put up for consideration. One of them did not get business support, there was no support for it; the second was a proposal which would have been costly to the Revenue and therefore a more selective change was suggested. That had a distributional impact between companies such that it might alter the nature of competition within the markets

HM Revenue and Customs

depending on the size of the company. As is often the case, there is a general agreement about the need to make it simple: it is when you come to the actual precise measures that the difficulties start.

Q11 Greg Clark: First of all may I make a declaration for the record that my wife is a tax accountant. When remarks like the Chairman's call for simplification of the tax system are made she gives me a funny look and reminds me that our family income depends on a degree of complexity. Nevertheless, I believe in simplification. This is a good Report, it shows some good practice, some good progress has been made and I congratulate the HMRC on that. May I ask about these area offices? According to page 10 you have 68 area offices. Do you actually need a local presence to collect corporation tax?

Sir David Varney: The answer is in theory no, although there would be a lot of travel if you only had one office. You do need a number of offices. In theory, you can have fewer. There are two conflicting pressures. We are growing the technology to be able to share the work in the places where we want it. It is a question of very skilled staff; it is question also of local knowledge.

Q12 Greg Clark: Yes, but 68? I can see perhaps a regional base but having 68 seems very local.

Sir David Varney: It goes from about five to 20 in each location and of course they are part of a much bigger command.¹ What we are looking at today is the work of about 2,000 people and in our area offices we have about 39,000 people. What we are seeing is a need for a more strategic set of offices, but there is also the local feel, knowing the local business, knowing local people, knowing the local agents.

Mr Tweddle: Up to 5% of the work will actually involve direct physical contact with the business concerned. One of the things is that over the history the areas were sorts of mini regions in themselves looking after all aspects of direct tax. One of the plans that we shall be taking forward as we re-engineer this work is to move to a smaller number of locations where we can build up the expertise and start to integrate it with other tax activities.

Q13 Greg Clark: It strikes me that if 95% of the inquiries do not involve any actual physical contact then the need for 68 area offices seems to be a trifle superfluous. It does not give you the opportunity to organise it in another way. It strikes me, for example, that although there might be some local areas of consistency between firms, there are far more likely to be common approaches across industries. The corporation tax affairs of retailers, cement manufacturers, whatever, will no doubt be more similar than firms which just happen to be located in and around Teesside, for example.

Mr Tweddle: We are moving in that direction and indeed, the pharmaceutical industry, for example, is treated in that sort of way. We do believe there will

be benefits in taking that further. Also, as you can see from the charts on page 18 of the Report, the average size of the offices is small and varying between the smallest which has about five and the largest fewer than 35 staff. I do not believe that they are big enough actually to give that scale of economy and efficiency that we need.

Q14 Greg Clark: Indeed, but I get the impression that this is incremental reform. Is there not the opportunity here for a real re-engineering in deciding that actually the connections between companies in a certain type of industry are more important than geographical location, especially if 95% of times you do not need to visit them? Therefore, rather than just inching that way, could you not tear up the whole thing and start again and over two or three years move towards an industry based structure?

Sir David Varney: We are agreeing in part, but there are some constraints which we shall need to build into this. This is not a cookie-cutter industry: this is trained professional staff who take years to grow in skill and expertise. What we are seeking to do is to invest in technology which will direct their talents more productively. So it is not that you could go to a small number of offices and suddenly recruit off the street the sort of people you need. In some part of this is a sort of tussle between where people are, where you would like them to be. We have been thinking about direction of travel, but this is part of a bigger problem of 40,000 people.

Q15 Greg Clark: I should just encourage you to think perhaps a bit more boldly in this direction and no doubt some people might be prepared to move. On page 30 of the Report, paragraph 4.4, you say that you have 1,100 staff working on corporation tax inquiries in 2004–05 out of a total staff in the areas of about 40,000. A very small proportion. What do the rest do?

Sir David Varney: There is self-assessment, non self-assessment schedule E processing, end-of-year returns, P45s, call centres, national tax and new tax credit callers. We have P11Ds, management support; we have income tax compliance, CT compliance, employer compliance.

Q16 Greg Clark: A whole lot of activities going on there, but 1,100 people working on corporation tax inquiries. Yet page 15, paragraph 2.8 says that some of the aspect inquiries generates 23 times their cost in revenue. My question arising from that is: do you have enough people? If they are managing to achieve 23 times what they cost, is there not an opportunity to have more people there and actually benefit the Exchequer?

Sir David Varney: This comes back to the issue of the small number of cases which produce the yield. We are obviously concerned about looking at whether the coverage we have is at the right level. We are doing more research on that. It is always tempting to think that you get a very high yield because you have more staff at it, but actually of course the yield that you get is an average and the question is how quickly

¹ *Note by witness:* Correction: The number of staff in each location ranges from five to 33 (not 20) individuals.

 HM Revenue and Customs

it declines, what the marginal yield is. The fact that we have some failures to gather CT and maybe in some cases even anything on directors, suggest that that is about the right resource. In most of HMRC the dilemma is, given the resources you have, where to deploy them for the maximum benefit.

Q17 Greg Clark: On that point, I was looking at your Report and accounts and you helpfully compare the yield-cost ratios for different activities. I could not help noticing that you have these very high figures. We have seen 23 and 12.9 is a broader average for corporation tax aspect inquiries, yet for self-assessment business inquiries it is typically a yield of three to one. So 23 to 1, versus three to one suggest to me that perhaps some more people should be working here and perhaps fewer people on some of the income tax or self-assessment activities.

Sir David Varney: If I might just take the logic a bit further, in things like serious compliance, which is our heaviest form of investment in evasion, which is highly targeted and we use many of the powers that we have, we have an even higher yield than 23. Our anti-avoidance group has very high rates of return and there is a balance of how much resource you deploy for what benefit. What we do feel is that we need to do more research in this. Bringing the two departments together also raises new issues in terms of their different experiences of compliance in both VAT and in terms of income tax and corporation tax.

Q18 Greg Clark: May I invite you to do that with some urgency? There is an important point which arises from that, which is that there is always pressure from the Treasury and from your experience to close loopholes and to squeeze more revenue out of the existing tax system and that is obviously right. The temptation is of course to change the rules and to sort of fiddle with them and close loopholes, which causes a lot of complexity which the Chairman talked about, whereas in actual fact if you could get the same increase in revenue from the existing rules by just enforcing them better, then that is better for business all round. So it is important for the structure of the tax system that you do have the right number of people here and it is not just a figure that denotes your efficiency but is actually very important from a policy point of view.

Sir David Varney: I agree with that and the fact is that we have been conducting fewer inquiries, getting a higher yield and overall the amount of money that we are collecting in corporation tax has been high. I do agree with you but it is not a question of giving it more urgency, we are giving it a lot of urgency. It is having a factual base on which to make real decisions.

Q19 Greg Clark: In terms of the administrative savings that can come from electronic filing and this sort of thing, obviously it is desirable that you should make them. I was just slightly surprised to find in the Report on page 30 that you expect only to be able to make savings equivalent to 30 staff

through savings in processing by 2007–08. Out of 1,100 30, with all the advances in technology, seems—

Sir David Varney: Savings would be in the processing area rather than the inquiry area.

Q20 Greg Clark: Indeed, of course. I am not suggesting you have more, but in the processing it strikes me that with savings that might be possible through technology, to have 30 people saved over a network of 68 offices is less than half a person per office and does not seem terribly ambitious on the administrative side.

Sir David Varney: It will take time. We want to get data in a form which is called XBRL, extensible business Reporting language, which has the advantage of labelling data with its place in the accounts when we get data in that format. So some of the savings you are seeing partly reflect the number of people involved, partly they reflect a cautiousness about how quickly this filing will come in.

Q21 Mr Mitchell: It all looks very haphazard to me as a mere taxpayer. There we all are as taxpayers hounded by Adam Hart-Davis telling us to get it in or our wives will all leave us and our children will die and all sorts of things and the horrendous penalties of being late, yet you are carrying on in a fairly haphazard fashion. You have no idea what the tax gap is, how much companies are paying below what they ought to be paying. You do not look at other taxes due from companies except in 9% of the cases, which I should have thought was a strange way of proceeding, and you have no idea of the effect of penalties when they are exercised. Why is it so haphazard?

Sir David Varney: It is not haphazard. You can not cut the number of inquiries in half and increase the yield by 42% by a random walk in the dark. I do not buy that for a second. No country has a robust way of identifying the tax gap for revenue and corporation tax. We have just seen a recent Report which has tried to assess corporation tax and having been the Chief Executive and Chairman of two of the PLCs, I can look at the figures with a degree of expert knowledge of what those figures are and it is very difficult for outsiders to be able to work out what the tax position is. What we are talking about is a stock and flow of money and it is quite difficult for outsiders to understand what is going on in the tax books; they can know what is going on in the published accounts. What we are doing is trying to run a risk management exercise, to make a deployment of resources commensurate with the risks involved to the Exchequer and that is done over a number of offices. If you are in HMRC, given the number of offices we have, the number of people, the number of businesses we deal with, you would expect complexity. However, that is not haphazard, that is an attempt to try to deal with what is a very complicated organisation with lots of interfaces.

 HM Revenue and Customs

Q22 Mr Mitchell: But it looks as though you are being much kinder and gentler or dilatory with companies than you are with individuals.

Sir David Varney: You will not find many companies which would agree with that. Our job is not to hound people: it is to help the people who want to comply.

Q23 Mr Mitchell: Your job is to bring the money in.

Sir David Varney: Our job is to help people who want to comply to comply and to bring those people to account who are eroding the tax system by seeking to evade taxes.

The Committee suspended from 4pm to 4.07pm for a division in the House.

Q24 Mr Mitchell: I was just arguing, hypothetically of course, that you make it sound like this is some kind of voluntary donation and it is your job to facilitate it, whereas in fact it is a tax. It is the rent that companies owe for being able to operate in this country and it is your job to get as much out of the bastards as possible.

Sir David Varney: My job is to enforce the law enacted by Parliament. I should find some conflict between the term “bastards” and getting the most money out of them commensurate with their obligations under the law.

Q25 Mr Mitchell: Yes, but this is a far more accommodating attitude than is taken to the ordinary individual taxpayer.

Sir David Varney: I do not think that is true. We are dealing with a large number of companies. We deal with individuals. We try to deal with everybody on the basis of fairness and what is appropriate under the law. We should have an advert encouraging people to use our whistle-blowing service, which people already use, which is across the whole gamut, whether individuals or companies.

Q26 Mr Mitchell: The random inquiry work found that 40% of the returns contained errors. In whose favour?

Sir David Varney: The Report gives an indication of the top three errors. The first one was understated sales. You would normally understate sales for the benefit of the owners of the business. There is personal expenditure, putting private expenditure through a corporate vehicle, which would usually be for the benefit of the private individuals. The section 419 is loans to directors. So the top three would be of benefit to officers who would be understating their incomes and that is why there might well be a yield in terms of their income.

Q27 Mr Mitchell: What happens to those who persistently make errors in their favour? Are they scrutinised more rigorously?

Sir David Varney: Yes, obviously and there are penalties that can be laid there up to 100% of the tax. We have a regime which we have to go through which Parliament has laid down in terms of what is an appropriate penalty to put in place.

Q28 Mr Mitchell: Why is there such a wide variation in performance between areas? Is it a question of smaller offices or more remote offices being hicks from the sticks and companies giving them the run-around or what is it?

Mr Banyard: Companies are not giving them the run-around, but some of the areas are quite small and so the performance variations you get are magnified simply because of the small number of people involved. They are also magnified because you are only taking a one-year snapshot here of work that runs over a couple of years or so. Although we have not run a two-year average we should expect the variation between offices to be quite a bit smaller if we looked at two years as a whole. Yes, there are variations and we are going to use this Report to help us drive the lower performing areas up to the performance of the higher ones, but these figures give a very stark picture which is only a snapshot.

Q29 Mr Mitchell: So where should I set up my company if I want to pay less corporation tax?

Mr Banyard: There is no place where we could safely suggest you set it up if you want to avoid.

Sir David Varney: But there is something in what you say about areas and if you were to take figure 12 you would find that there would be a function of areas. In some areas, of course, you have large numbers of companies and therefore you have the staff who can build up large amounts of skill and interchange; in others you have much less economic activity and therefore you have less coverage.

Q30 Mr Mitchell: It is striking that while income tax has been rising fairly steeply, corporation tax has not. A number of reasons are given in the Report, but is one of the basic reasons the fact that companies are establishing themselves offshore?

Sir David Varney: No, we do not see that. If you look at figure one on page 10, if the Chancellor were here he would be talking about the fact that he made two corporate taxation reductions from 33% to 31% in 1997 and then in 1999 to 30% and that led then to a decrease in corporation tax returns. More recently corporate profitability has increased and therefore corporation tax receipts have gone up, although it is still a small proportion, about 13% of our total tax take from the population at large.

Q31 Mr Mitchell: But given the fact that the economy has grown so much, the number of companies has increased, you would expect corporation tax to be higher.

Sir David Varney: The Chancellor has reduced tax; he also has an agenda in terms of looking at the competitiveness of our tax regime against other countries. At the moment we think this year we shall collect something like £42 billion which is up 26% on last year. That reflects partly corporate profitability; it partly reflects the rising oil prices and therefore profitability of the North Sea. That is really a judgment for Parliament. My job is to collect what you ask me to collect. It is your job, with respect, to determine where you wish to levy it.

HM Revenue and Customs

Q32 Mr Mitchell: Suppose I decided to establish Mega Mitchell Corporation.

Sir David Varney: That would be high risk.

Q33 Mr Mitchell: Like News International or like Virgin in some tax haven, what happens then? Is no assessment made at all for corporation tax purposes?

Sir David Varney: Let us take the general case of Mega Mitchell, a hypothetical company, typically that company would have a large number of subsidiaries. What we would be taxing is the subsidiaries in the UK that were here. We would be looking to see whether there was economic activity which was done in the UK and which was properly accountable for UK tax.

Q34 Mr Mitchell: The profits were to a trust in Liechtenstein or British Virgin Islands or somewhere and the question is: what taxation is possible on profits earned here but actually channelled through tax havens?

Sir David Varney: Well there is a fair debate and we are in front of the House of Lords from time to time on the interpretation of tax law and what is accessible and the fact is that at the moment tax revenues from corporation tax are rising.

Q35 Mr Mitchell: Slowly.

Sir David Varney: It is for you to make that judgment, not for me to make that judgment.

Mr Banyard: We have legislation which seeks to prevent profits on economic activity in the UK being shifted to tax havens. We have transfer pricing legislation and we have controlled foreign companies' legislation, which attempt to keep in the United Kingdom profits and the tax on the economic activity which is generated here.

Q36 Mr Mitchell: It is always interesting to know what proportion of its earnings a corporation like News International pays in tax in this country and what proportion just goes offshore. I bet the overwhelming proportion goes offshore.

Sir David Varney: We are not allowed to comment on individual taxpayers.

Chairman: If you want to do better you should employ Mr Clark's wife to give you some advice.

Q37 Angela Browning: Sir David, in one of your earlier answers to the Chairman you said, and you repeated it in another answer, that 10% of effort goes into random inquiries. Are you not just fishing in the wrong pool here? When you say they are random inquiries, surely the art is in getting a better return for the amount of resources you are spending on trying to recover corporation tax? Would it not be better if you had a lot more focus, for example, by way of sector or some other way of disaggregating all these companies so that you get a better return? What actually are you doing in order to do that? From what we have heard, it still sounds pretty random.

Sir David Varney: 90% of our activity goes into targeted risk assessment activity. We do not have full knowledge of what the risk is that we are managing

out there, so the percentage of random inquiries is to drive out and improve our knowledge and intelligence of two sets of issues: are they systemic errors which regularly happen, which by better education we can eradicate from the system? Then, what is the nature of risk and how is it changing? So, we have to make a judgment. Our judgment was that 10% was about the right level of resources to devote to this, because the people we use cannot be used on revenue raising errors while they are used on random inquiries and they are pretty high cost.

Mr Banyard: I was just going to add that we do 4,500 full inquiries, where we go into books and records. Four hundred of those are in the random programme, which enables us to see where the risks are and whether our risk analysis is actually picking up the key risks and you need the random programme to give you that assurance.² The other 4,100 cases are selected on the basis of risk analysis and our strike rate on those, or our success rate, is 81% which is as good as any other fisc in the developed world as far as we are aware. On top of that we do some 39,000 of the aspect inquiries where we are going in and perhaps looking at just one particular point where we are not sure whether the tax treatment is right or not.

Q38 Angela Browning: If you look at what the Report tells us, on those full inquiries specifically not the aspect inquiries, we are told that the median for the additional tax yield is £7,200. When you compare that with the costs of those inquiries, for example at paragraph 4.4 on page 30, it shows the staff costs and at figure 12, which we looked at earlier on page 31 next to it, you can see that the staff costs on those full inquiries are between £3,600 and £9,800. That does not seem to me to be particularly good value for money.

Mr Banyard: The full inquiry has an average yield of £27,000.

Q39 Angela Browning: Then the figure I have read must include the aspect inquiries.

Mr Banyard: The random inquiries bring in a yield of a tenth of that.

Q40 Angela Browning: If the random inquiries bring in a mean of £7,200, which is quoted in the Report, what is the actual cost then of these random inquiries?

Mr Banyard: The cost of a random inquiry will be roughly the same as the average cost for a full inquiry.

Q41 Angela Browning: So between £3,600 and £9,800.

Mr Banyard: Yes, an average of £5,600.

Q42 Angela Browning: So all these random inquiries that you are doing could actually cost you more than you are actually recovering.

² Ev

 HM Revenue and Customs

Sir David Varney: May I go back to what I was saying? We are trying to prove that our risk selection for the 90% is accurate and if we do not invest that money, we will never know. We have a dilemma.

Q43 Angela Browning: You do have a dilemma.

Sir David Varney: Yes. HMRC is a bag of dilemmas. The issue is that if on the other hand we were finding a big yield on our random inquiries, bigger than we were finding on our directed inquiries, it would raise serious questions about our risk management.

Q44 Angela Browning: So that 10% is a sort of control exercise?

Sir David Varney: Yes, and it is part of trying to find out more about what Mr Mitchell asked about which was the tax gap, trying to inform what is the nature of the underpayment opportunities that corporates are exploring.

Q45 Angela Browning: May I turn now to the so-called burden on business? If we could just look at page 16, figure 5, we see the figures here under figure five for the 2004–05 Report “Proportion of enquiries with no change in outcome” and we see that just 19% are full inquiries, it does not seem too bad on the face of it. What I want to know is what it actually costs those businesses where you do not get a result? For example, if you get it wrong and your inquiry shows that actually there is nothing extra to pay, there is no case to answer, what does it actually cost that proportion of businesses in order to deal with or respond to a full inquiry?

Sir David Varney: All this says is that there is no change in the outcome of corporation tax. There may be other changes. In terms of the burden on corporates, what the Chancellor announced in the budget and the PBR last year was that we were going to focus on small- and medium-sized enterprises. So we have been doing work on the administrative burden on small- and medium-sized enterprises and the Chancellor is obviously considering where the work is and what he wishes to do with it. We have had some discussion with the medium-sized enterprises. I think I am quite right in saying that actually corporation tax itself and the burden, was not the key issue.

Q46 Angela Browning: But the inquiry itself was?

Mr Tweddle: No, it was other areas of the taxation system which were creating the burden. Corporation tax itself was not.

Q47 Angela Browning: May I ask you about the decision that the Chancellor has now made to bring into the fold companies with profits of under £10,000 in the next financial year, 2006–07? I do not quite equate why they should now be brought into the fold for potential investigation when in fact you are trying to remove the burden from the smaller sector of businesses.

Sir David Varney: Our job is obviously to implement the policy which the Treasury decides and the Treasury would be better able to give you their thinking. As I understand it, we were seeing a large

number of incorporations which were being motivated by this zero rate return and when the Chancellor made his announcement, there was broadly support for what he was doing.

Q48 Angela Browning: From your perspective, in terms of the job you have to do for recovery of corporation tax, surely if you are serious about fishing in the right pools, you are not going to get much return in that group, are you? Are you going to ignore them or are they going to become part of the—

Sir David Varney: No, they are part of the risk. Clearly, we have seen a large number of incorporations of companies, much larger than could have been expected from the economic activity. We shall have to work out what the risks are.

Q49 Angela Browning: But the figures show that two thirds of companies have tax liability of less than £1,000. In terms of return for the investment you put in, are you saying, for example, that whatever category of investigation you make into them the return on the staff costs and the costs of the inquiry equates in terms of getting good value for money? I just come back to my original observation that you seem to be fishing in the wrong pool.

Sir David Varney: Let me just say again that we have halved the number of inquiries and increased the yield by 42%, so we may be fishing in the wrong pools, but we are successfully raising money whilst being selective in the fishing. We have looked at yield. Our yield has increased in both full inquiries and aspect inquiries over the last five years and the numbers are in the Report. We have been lowering the number we do and been getting the yield up and we ourselves are neurotic in a sense about whether we are fishing in the right pools, that is why we do the random programme.

Q50 Angela Browning: You said that you are going to try to improve this area, but what actually in practice are you doing?

Sir David Varney: We are investing in trying to use better computer risk analysis, better databases for targeting. We are also trying to bring together expertise across HMRC. We have, separate to this area network, a large business service which deals with the 800 largest groups in the country who between them have 30,000 companies and whose affairs are incredibly complicated, but that is also to help with better risk management. We are looking at more strategic focus in terms of where we have the expertise and we are doing more team working to use the scarce resources of senior tax inspectors in the most productive way that we can.

Q51 Angela Browning: I realise this is an incomplete process, that you still have more work to do, but as you look at it at the moment, where do you think the answer is most likely to come from. Is it going to be, as far as business is concerned, sectoral or is it actually regional in terms of where you have the expertise and where the hubs of business are based?

HM Revenue and Customs

Mr Tweddle: The answer is that it will be sectoral. What we want to do is actually build up to the best practice where the risks are and then to focus that in a national way. So it will not really matter where the business is based; we shall actually be having a national assessment of the risk and making a proportionate response with our intervention resources to meet that risk.

Q52 Angela Browning: The reason I am interested in that is because very often, not just in relation to corporation tax but in terms of the Inland Revenue and taxation generally, there is sometimes a view that there are disparities regionally between tax inspectors' interpretation of the law. I just wonder how much of a weakness that is in what you are trying to do.

Mr Tweddle: If you turn the clock back a number of years, the tax inspector was the lord of the tax in the area they were and they had quite a strong influence over deciding the risks and what should be investigated and inquired into and what not. Over time, we are recognising, while we still want to get that local input and local knowledge, that we need to have a more national approach. We have had too many cases where somebody has had a particular idea that this is a risk area so let us do that, not taking cognizance at all that other parts of the country have already studied that and done that and got expertise in it. As we develop our national risk picture and we develop a more centralised approach, we shall actually get a better balance of local initiative and central and national direction.

Q53 Angela Browning: That is encouraging and I hope that works because clearly it is quite unfair to certain individual companies and to certain companies in certain regions, if you have this disparity around the country as to how they are treated by the Inland Revenue, which actually should be presenting a national standard uniformly as far as the business sector is concerned. I just wonder whether you have any idea at all of what the cost to business is from that grouping which actually does come under your investigation but where there is no case to answer.

Sir David Varney: People are much quicker nowadays to give us feedback if we have these disparities; so we are working on that and the sector approach. The other thing is that there are different segments of the corporate world which have different levels of profitability as sectors and we have obviously got to move and concentrate on those which are likely to be tax paying.

Q54 Angela Browning: Perhaps I could just conclude by saying, as Mr Clark made reference to it, that I am married to a retired accountant who always spoke very highly of his dealings with the Inland Revenue.

Sir David Varney: Good man.

Q55 Mr Bacon: I must say that I did have an inquiry with the Inland Revenue about what you do about selling property and I have to say they were very

helpful when I spoke to them on the phone and got to the right person. Thank you for that. I want to start with questions about electronic filing. The Report says that fewer than 2% of returns are filed electronically. Could you say how many of the 2% of returns are from among the 900 Large Business Service groups of companies and how many are from the other much smaller companies?

Sir David Varney: We think 2% is local compliance, but we shall check the answer. It is companies within the realm of this Report.

Q56 Mr Bacon: What I am referring to is the distinction referred to right at the beginning on page 1. There are 900 groups of companies dealt with by the Large Business Service; 900 companies which pay £18 billion. I am just wondering how many of those are included in this 2% figure in paragraph 3.9 as filing electronically and, correspondingly, how many of the 1.1 million companies also referred to on page one are filing electronically.

Mr Banyard: Most of the companies that are filing electronically at the moment are the small companies.³

Q57 Mr Bacon: Really?

Mr Banyard: The electronic service at the moment does not accept the accounts and the associated tax computations. The tax return itself is sufficient for us to make a corporation tax self-assessment. To do a risk assessment, we need to see the tax computation and the accounts and we allow companies to submit them in a free format. We have developed, along with other groups, a computer language, to which Sir David has referred, the extensible business Reporting language, which allows companies to submit their accounts and computations in their own format, but the data is tagged and will therefore go into our systems. We have just introduced that.

Q58 Mr Bacon: Was that in November 2005?

Mr Banyard: It has come in recently, yes. It started in February.

Sir David Varney: In the Report it said November, but it took more time to get the taxonomy. May I be clear with you, because there is a very important difference? What we can receive at the moment is input electronically, but we cannot read it electronically.

Q59 Mr Bacon: Indeed. The Report says "Companies have to save the accounts and computation in a 'pdf' . . . format and submit them with the electronic return. As such, external stakeholders told us that this provided few advantages over paper submission, except that the electronic return had in-built checks to help correct

³ *Note by witness:* Around 7000 company tax returns were filed electronically during the year ended 5 April 2005. During the period 6 April 2005 to 6 March 2006, around 21,000, approximately 2%, of company tax returns were filed electronically. As Mr Banyard said, most of the companies that are filing electronically at the moment are the small companies. The numbers of LBS companies filing electronically, as a percentage of the whole, are so small that they do not affect the 2% figure.

HM Revenue and Customs

and it provided an immediate acknowledgement". The Report goes on to say that your new facility "... will avoid the need for submitting documents in pdf format". Presumably the ideal solution is where they submit their data and you receive it and then can immediately read it electronically, rather in the same way you just e-mail somebody an XL spreadsheet, they are able to read that instantly and we are all familiar with that. You are saying that you cannot do that at the moment.

Sir David Varney: What we needed to do was develop a taxonomy of what each bit of data means. What we have had to do is take a tax return, think about the vast array of companies we deal with, what goes in those returns and then how uniquely electronically to identify the taxonomy. So when they say they are going to give us a number 100 and that is stock work in progress, we receive it as 100 stock work in process and then we can start to analyse.

Q60 Mr Bacon: I am startled, though on reflection it is not surprising, that 55% of your corporation tax comes from just 900 companies; that is very small universe, a very dealable-with group.

Sir David Varney: And very profitable.

Q61 Mr Bacon: And very profitable. One would have thought therefore that that was the bit where you would most quickly and most easily get computer filing because it is easiest for large companies to do it, I should have thought, and easiest for you to receive it. I notice in the Report it says that in the United States, the Internal Revenue Service is making electronic filing mandatory from December 2006. Are you planning to do that?

Sir David Varney: Well this is obviously a subject, to go back to a favourite topic, which Lord Carter is considering and will no doubt give advice to the Chancellor on. The corporates on the bigger side have very complex affairs; we have many more exchanges with them. This has also been somewhat hampered by there not being a consensus among tax authorities about a standard that you could use for the taxonomy. At the moment we have got to a sort of best OECD guidance that this is a preferred route and each country has almost got to create the taxonomy that is appropriate for its tax code.

Mr Banyard: Companies House have now introduced this form of data capture. We are bringing it in at the moment. We have in place the infrastructure which will enable companies to submit their data electronically. Lord Carter is looking at how we encourage them now to do that and we shall act in the light of how Government decide.

Q62 Mr Bacon: Are any of the 900 companies in the large business service group currently filing wholly electronically?

Mr Banyard: The answer is that I do not know at the moment. We can find that out for you, but at the very best they will only file the corporation tax return and the pdf document around the rest.

Q63 Mr Bacon: My next question really is whether you could cope if there were more. You have had problems with the ERIC system, with PAYE, notoriously there have been problems with tax credits and many of these are computer derived problems. If there were to be a massive upsurge in the desire among the corporates to file electronically, are your computer systems up to it?

Sir David Varney: We think so. We do not think it will be quite an upsurge; it will take time to come through.

Q64 Mr Bacon: May I ask whether this comes under the ASPIRE contract you have with CAP Gemini?

Sir David Varney: Yes, this will come under that contract.

Q65 Mr Bacon: How is that going? I presume CAP Gemini would say it was going very well since they have just announced huge profits from it, but from your point of view how is it going?

Sir David Varney: Let me start by saying that it could always be better. I am an ambitious customer wanting even better services. They have done some things incredibly well. We have done the re-positioning of NIRS, one of our biggest systems. It is probably one of the biggest re-positionings done in Europe last year and that worked.

Q66 Mr Bacon: Of the National Insurance Recording System?

Sir David Varney: Yes. We had some problems inevitably, small numbers not large. On other things they could do better and I am encouraging them to lift their performance. The computer system that we currently have on corporation tax, which is a legacy system, had 26 minutes of non-availability last year.

Q67 Mr Bacon: That is pretty good.

Sir David Varney: In the nature of newspaper Reporting in this industry IT problems get Reported quite copiously; IT successes tend not to fill the pages. On self-assessment, we did get record numbers of people electronically filing and the system this year did stand up.

Q68 Mr Bacon: Why are you hiring new senior IT staff? There are adverts in the computer press this week for that.

Sir David Varney: Our continuing need to keep professional skills to make sure that we do not have the litany of problems that you mentioned earlier. In world-class terms, our IT infrastructure is a world-class set of challenges. There are few corporates in this country that deal with the number of people, the number of companies, the amount of money that we have to deal with. We have 250 computer systems; we did 1,200 software releases last year.

Q69 Mr Bacon: How long is it before we should expect that your work on electronic filing is going to enable a fundamental rationalisation in your return processing centres? What would be the cost impact on that?

HM Revenue and Customs

Sir David Varney: You can expect that there will be some changes as we have talked about in the Report. Obviously what will happen, and this is a common ground for us and the union, is that the jobs which will evolve over time are the more specialist jobs, knowledge jobs, looking at electronic data and setting up risk management processes and directing staff to where the risks are. In a sense what is going to happen in tax is what has happened in the oil industry in terms of seismic exploration over the last 30 years. We are going to see more people coming along working with more knowledge tools. Then what tends to happen is jobs are created which are different from the ones you have today.

Q70 Mr Bacon: I have been told by constituents running small retail outlets that big supermarkets are channelling their sales of DVDs and CDs via the Channel Islands and therefore they are unable to compete with these big supermarkets. Is that something that you would look at on the basis that it is economic activity in the end occurring in the UK, or would you be saying that because the price at the outlet is correspondingly lower for whatever tax related reason along the way, it is not a matter for you? Is it something you would look at or refer to the OFT for example?

Mr Banyard: This is really a matter for ministers. It is a question of where the VAT limit is set as to whether or not it is charged on an import and if there is a single import under £18, then VAT is not charged. It is a matter for the Chancellor, where he wants to set that limit.

Q71 Kitty Ussher: On reading this Report, like Greg Clark, I was fairly encouraged by the performance and the progress that has been made, but I want to push you a little bit further on the issue that he actually raised, namely the difference between the average yields on compliance investigations and the marginal ones. By the way, first I have to say I also have a husband who is an accountant, which is an interest I should declare, but he is a management accountant rather than a tax accountant so perhaps we are spared in this case. It would be interesting to see whether there is a correlation between accountants who are spouses and members of the Committee of Public Accounts. Perhaps that is something we should investigate. We are looking at page two of the Executive Summary, paragraph seven. Aspect inquiries yielded a yield 23 times their cost; full inquiries had a yield five times their cost. Initially looking at this you would think we should devote far more resources to doing these types of inquiries, but you said earlier that obviously that is an average and you felt that the marginal cost of an additional effort was far smaller. Could you elaborate slightly on that? What work has been done?

Sir David Varney: Our random programme indicates that it is a small percentage of corporates which are essentially responsible for under-reporting their income. Let me put it like that. Therefore what we need to do is target the resources to those. That is clearly a limited pool and the aspect

inquiries, which we have to open if we want to ask questions of a corporate—we are not allowed just to ask questions without opening an inquiry—are what I would call the very light-weight ones, £500, £600, going in, seeing whether there is a yield or not. It is a mistake to think that you could stop doing these aspect inquiries and if you put them into formal inquiries you would necessarily get the same yield that you got over the full inquiries before. So you are in a curve of declining yields and you have to make the choice about how you best deploy your staff given the mix of approaches you have. It is also a question of proportionality. We need to work with the grain as much as we can unless we think that people are out-and-out villains trying to undermine the tax system, in which case we shall use all of our powers. By and large, we need to work with people in order to get to the right answer on their obligation to society.

Q72 Kitty Ussher: I am sure you feel that you are deploying the resources currently available to you in the most efficient way. I would hope that you do think that. My question is: should you not get more resources? Will the taxpayer not be better off if you are able to do more full inquiries and aspect inquiries because they yield a return to the taxpayer?

Sir David Varney: All of the compliance parts of HMRC would be arguing that they have got high yields and they are a source of more yields. From time to time we do spend-to-saves and when I have Reported on those some of them are good news and we do get the money, more than we have got and we learn from that. In others it is disappointing and we do not get the yield. You have to make a judgment about how many resources we have. We are not also talking about cookie-cutters: we are talking about people who have lots of expertise, training, professional knowledge, who do a professional job and there is a limit to how many of those people we have on our staff and we can attract and retain.

Q73 Kitty Ussher: Let us say tomorrow the Chancellor were to give you a modest sum, another £200,000 to spend on attracting and recruiting staff.

Sir David Varney: He is modest. I hope he would be more generous than that.

Q74 Kitty Ussher: I know, but we are talking about marginal costs here. Let us say he did, so you could afford to recruit.

Sir David Varney: In £4.3 billion, £200,000 is really. . . If he gave us extra money, if you were looking on a yield basis, you would probably get the pattern you see on the spend-to-saves, which are things like some work that has gone on in anti-avoidance and serious compliance and there would be some activities which we have run which have come on the spend-to-save. Our experience of those is mixed.

Mr Tweddle: You talk about marginal costs, but the real marginal cost is one to 100, because if you look at the cost of collecting corporation tax and the total receipts, even a return of 25 to one would actually bring down the average cost.

 HM Revenue and Customs

Q75 Kitty Ussher: Let me keep this very, very simple. Are you saying to me that if you were given a marginal extra increase to spend on staff to do more full and aspect inquiries, you would be able to yield a higher return to the taxpayer? If we gave you £200,000 how much would you produce back? You must know the best way to use that money.

Sir David Varney: What we are saying, and this is the challenges the NAO have put down and we are keen to pick up, is that the most effective use is to deploy the resources we have better and that is our first port of call. There is scope for us to improve our efficiency and I think the Treasury will take the view that they would want to see us closing the efficiency gap. It would probably be more at regional level before they would start entertaining the view that we could do with more resources.

Q76 Kitty Ussher: I am sure that is the case, however this Committee is concerned with the overall value for money for the taxpayer, so it is perfectly valid for us to ask the question: will the taxpayer be in an improved situation? Will the Exchequer have more money overall, if there were more invest-to-save type projects and we resourced you accordingly?

Sir David Varney: As I said, on the invest-to-save, what has happened in the individual cases where we have done it, is that some have delivered results which are positive. Where that happens, that then tends to get baked into the HMRC plan for the next financial year. Where it is unsuccessful, we withdraw from it and do not put more resources in. Where we are at the moment is that our priority is actually getting better risk management and a more efficient deployment and use of the resources that we have and that is in the best interests of the taxpayer.

Q77 Kitty Ussher: So the marginal cost is not yet quite zero, there is potentially scope.

Sir David Varney: Yes. It is always a tempting issue in compliance. It is a central issue. The compliance which tends to be at the margin talks about very high rates of return and from time to time we have invested in it. It is why the random inquiries are so important to us, because it builds up a better picture to take better risk decisions than we have done in the past.

Q78 Kitty Ussher: A slightly different version of the same question. Sir David, you have extensive private sector experience. Do you feel when you are allocating your resources in certain ways in order to maximise value for the taxpayer that you are effectively making the same judgments as you would do if you were trying to maximise value for the shareholder in your previous incarnations? Are you using the same methodology?

Sir David Varney: First of all, it is much more complicated because in the number of products we have in terms of taxes and regime, the management information system is not good enough to make the sort of decisions we have to make and that is why we are putting in a SAP enterprise resource planning system which will give us better data about people and their use of time, to do the sort of statistical

analysis that the NAO have done in an easier way, do more comparisons. I would say we are making decisions in the same sort of way I would have done in private industry. In private industry I should have had two benefits: one is that I should have been a simpler organisation in terms of products; and secondly, the management information system would have been considerably better.

Q79 Kitty Ussher: Do you think in your time here you will be able to improve the systems and the processes sufficiently to be able to have comparable decision-making?

Sir David Varney: SAP will make a big difference if we can get it to work. We are set on a path. I should like to feel that my contribution is to start it down this road and that some of my colleagues will be able to take it much further.

Q80 Kitty Ussher: I just wanted to ask you a little bit about the penalties that you impose on companies who have not complied or who have been negligent. I am being negligent myself by focusing on the Executive Summary which is paragraph eight, page two. Could you just perhaps, by way of introduction, say a little bit about where you can impose penalties? Do you feel that this is an area where you could get a greater return to the taxpayer by imposing greater or more extensive penalties?

Sir David Varney: We can impose a penalty, but we have to meet three tests. We have to show that an incorrect tax return has been submitted. It has resulted in a tax difference and the error arises from the negligence of the taxpayer. Negligence has a fairly specific definition. It is the omission to do something which a prudent and reasonable man would do—or woman. That leads us into some quite interesting areas. If a company relies on its professional advisers and that professional adviser has given advice and it follows that advice and that advice turns out to be wrong, we probably would not be able to sustain a penalty because he had reasonably taken advice. In terms of the inquiries settled in 2004–05, penalties were imposed in 51% of the full cases and only 5% of the aspect cases. That reflects in a sense that the full inquiries would have produced something where we thought a penalty was appropriate; an aspect one we could have resolved fairly quickly or come to a conclusion that there was some reasonable doubt.

Q81 Kitty Ussher: Do you think the regulations should be changed, in particular around the issue of advisers? What you have just said seems intellectually unsatisfactory.

Sir David Varney: Parliament was trying to strike a balance between what we can do in terms of penalties. We are looking at it in terms of the powers' review and what I hope we are going to see in the powers' review is that we shall be granted powers which are commensurate with the job we have to do and this will be one of them that we shall look at in the context of the wider powers. I rather favour taking a balanced view so that we have a coherent statement of powers which are commensurate with a

 HM Revenue and Customs

modern HMRC, rather than what I have at the moment which is that I can only exercise the powers of the income tax commissioners or of the revenue commissioners.

Q82 Kitty Ussher: Fixed penalties seem to be incredibly low compared with the turnover of the companies, that is the fixed penalties for not supplying information. Do you think, yes or no, that they should be increased?

Sir David Varney: It is an initial penalty of £50 plus £30 per day. Obviously if you are a company of reasonable size, this is a relatively modest inconvenience. If we start to get penalties from you for failing to answer our inquiries, we are likely to become rather closer acquaintances than we might hitherto have been.

Q83 Mr Davidson: Paragraph 2.12 says “. . . random enquiries detected errors by companies in around 40% of returns”. Can you tell me whether or not that was 20% paying too much, 20% paying too little or was there a different balance?

Sir David Varney: About 4% of the cases account for about 75% of the tax which we felt was from that population. So if you look at the 40% and take that as 100%, we think 4% of that 40% was responsible for 75% of the tax that was underpaid.

Q84 Mr Davidson: That was not quite my question.

Sir David Varney: I know; but to be honest, I do not have the figures. We can look, if a note would be helpful.

Q85 Mr Davidson: Because if it were 20:20, you would think that was just . . .

Sir David Varney: No, this is net. The number I am giving you is net. I cannot give you the proportion of how many, although help may be coming quickly.

Mr Banyard: The vast majority of the cases have an adjustment in our favour. A small number have the adjustment in the taxpayer's favour.

Q86 Mr Davidson: I must confess that was what I had thought: around 40% of people are underpaying their tax in those circumstances. In the Report that we have here of the three most commonly mentioned types of underpayment, of error, business receipts being understated is the first. Understatement of business receipts does not seem to me to be an error. That seems to be a deliberate deceit or a fraud. Is that not a fair way of looking at it?

Sir David Varney: It is one way of looking at it. Some people's book-keeping and record-keeping might leave something to be desired.

Q87 Mr Davidson: Indeed it might.

Sir David Varney: You have gone to one element, but in some cases it might actually be just carelessness and misunderstanding and somebody not really understanding what their duties are.

Q88 Mr Davidson: I do understand that point, but you would expect in those circumstances, would you not, that of the cases where there was a

misstatement, if it was just random, half would be paying too much and half would be paying too little? When they are consistently understating the business receipts, that would seem to be more deliberate, would it not?

Sir David Varney: When you think about how you overstate the revenue, that is a different act than understating. There is almost no incentive in the system for overstating your revenue.

Q89 Mr Davidson: Indeed if there were an incentive in the system to understate your revenue, then you would manage to avoid paying tax, would you not?

Sir David Varney: Yes.

Q90 Mr Davidson: So if you manage to avoid paying tax, it is hardly reasonable to assess that as an error, is it really? That is a fraud.

Sir David Varney: It depends on the nature of the individual case. When I gave you the figures on the full enquiries, I said that, in 51% of the full inquiries we have run, we have come to the conclusion that a penalty should be levied.

Q91 Mr Davidson: I shall come onto penalties in a minute. The second example of the most common errors is the owner's personal expenses being included in the company's accounts. That does not seem to me to be the sort of thing that is random, that sometimes they have paid too much and sometimes they have paid too little. That smacks to me of fraud as well. The third one is loans made to directors without being taxed. That does not seem to me to be an error; that seems to me to be a fraud. Why I am asking this is that I have dealt with you in tax credit cases as well and you seem to be very moderate and reasonable and forgiving here, but you are not quite as reasonable and moderate and forgiving when it comes to tax credits and underpayments and overpayments in those circumstances. I am not quite sure why you seem to be applying a different set of standards here, where you are basically big softies, and on tax credits you are really quite tough. You are tough on poor people and soft on prosperous people. That is the assessment that I come to. Does that seem to you to be unreasonable?

Sir David Varney: Yes; absolutely.

Q92 Mr Davidson: I thought it might.

Sir David Varney: Good. I am glad we can agree on something. We are not forgiving errors. We have identified where in these corporates there is tax liability to be made. We will levy penalties if we think they are justified and we will change the risk assessment. As regards new tax credits, this is my tenth visit to a select committee in the 184 days you have sat since 1 September and I have had plenty of opportunity to account for and explain new tax credits, the stance we are taking and I have answered a number of letters from MPs. In some cases the thing I really would apologise for is the low standard of service we have been able to offer.

HM Revenue and Customs

Q93 Mr Davidson: I do not want to be unduly diverted, but it is this question of the differential in standards. You do seem to be exceptionally understanding and forgiving on things that I assume to be frauds.

Sir David Varney: I do not think we are.

Q94 Mr Davidson: Let me just come on to the question of penalties then. What are the penalties as compared with, say, the tax avoided in terms of the balance of risk? If I am considering whether or not I should put some of my personal expenses in the company's accounts, if the penalty is 1% of the amount that I might have gained by a tax fiddle, that is an acceptable risk. If it is 1,000% then I am certainly going to be much more hesitant about it. Can you give me an indication of the balance of penalties to money at risk?

Sir David Varney: If we find that there is a tax liability, we will collect the tax, we will collect interest and we will levy penalties up to 100% of the tax that was due.

Q95 Mr Davidson: So the maximum penalty I could get is the same again?

Sir David Varney: Yes.

Q96 Mr Davidson: Well that is not bad.

Sir David Varney: Plus interest.

Q97 Mr Davidson: Well that seems a pretty good bet to me actually.

Sir David Varney: We will bear it in mind when we come to your return.

Q98 Mr Davidson: Thank you. I thought you did not comment on the affairs of individual taxpayers.

Sir David Varney: True. I was not.

Q99 Mr Davidson: I take that point. I ought to say, Chairman, in terms of declarations of interest, that I am not now nor have I ever been an accountant. I have been married 30 years and I suppose you never know your spouse entirely, but to the best of my knowledge she is not an accountant either. May I come to the question of good faith, this accepting advice in good faith? If I am coming out of a public house and somebody says to me, who is maybe a doctor, that I have only had 25 pints of lager so am perfectly acceptable for driving and I drive off and argue that I took that advice in good faith, I suspect I would not get away with it. I remember when I used to be in a local authority that when we wanted legal advice, we would shop about until we got the legal advice that we wanted. I suspect very much that it is pretty much the same with tax accountants: you get one tax accountant who does not help you particularly, so you go off and get another tax accountant. In these circumstances, if particular accountants are found to be consistently making the same sort of errors when they are caught, what happens in those circumstances about the accountant?

Sir David Varney: We have to operate the penalties within the law that has been laid down and the law as laid down provides that if it is reasonable to accept professional advice, then we cannot levy a penalty. Clearly, if we see a behaviour pattern from a firm of accountants or groups of accountants which is systematically giving cause for concern, we would talk to them. If we were more seriously concerned, we would raise it with their professional body.

Q100 Mr Davidson: How many cases have you raised with the relevant professional body?

Sir David Varney: I do not have a number, but we can let you know.⁴

Q101 Mr Davidson: Many?

Sir David Varney: No.

Q102 Mr Davidson: Could you just let us have a note on that?

Sir David Varney: I am happy to do that.

Q103 Mr Davidson: Can I just be clear about this? If you identify within a particular company that there is a practice which is going on that you are ruling against and the company's defence is that they took best advice, would you then go off and see whether or not that accountant was applying the same advice to other firms? That would seem to me to be an obvious way to go.

Sir David Varney: Yes, that is part of the risk analysis. If your doctor, let us call your firm of doctors accountants, comes up with a company, one of the things we obviously look at is how many other companies were advised by this practitioner and whether he has given that advice to other companies which would obviously affect the risk register. I would just say that the vast majority of practitioners—and some of you are married to them—want to ensure that people meet their obligations. The vast majority are not shopping around looking for the dodges. We do quite a lot of educational work with the profession.

Q104 Mr Davidson: Let us not get carried away here.

Sir David Varney: I was trying to stop you.

Q105 Mr Davidson: We do actually have 40% understating their business receipts, including their personal expenses in the company's accounts and not taxing loans made to directors. This is the client group with whom we are dealing here.

Sir David Varney: But only 4% of those are responsible for 70%, so a lot of the errors are very small amounts of money.⁵

⁴ *Note by witness:* Since the creation of HMRC there has been one instance where HMRC have referred a practitioner to their professional body. In the four years prior to the creation of HMRC there were four referrals to professional bodies.

⁵ *Note by witness:* Correction: 5% of cases are responsible for 70% of the yield.

 HM Revenue and Customs

Q106 Mr Davidson: That is because the businesses are very small in many cases. They would probably cheat more if they had more money to cheat with.

Sir David Varney: No, we are dealing with—

Q107 Mr Davidson: You are a very generous soul. Could I finally raise a point in paragraph 2.8 where it says 40% of inquiries produce no change? That means presumably that 60% do produce a change. Could you just clarify for me the percentage of those that go up and the percentage of those that go down?

Sir David Varney: Few go down, most go up. As I said earlier, 81% of the full inquiries produce an increase in tax take and 58% of the aspect inquiries produce an increase.

Q108 Mr Bacon: Very quickly I should like to return to electronic filing. When do you think companies that want to do so will be able to transfer their accounts data directly to your computer systems?

Sir David Varney: This summer we think. In the nature of this, I should not be surprised if we uncover that there are some bits of the taxonomy that are not clear. I should not regard that as a failure, I should regard this as work in progress, trying to get this system to work properly.

Q109 Mr Bacon: When do you expect the new risk assessment database to be available to areas?

Mr Banyard: It is available now; we are rolling it out as we speak. I was talking yesterday to the pilot office which has been running it for six or seven months and they have had some very good initial work and results from it. We are reasonably confident that this system is good and that the offices that are using it are very pleased with it.

Q110 Mr Bacon: In what circumstances would you switch off the paper return facility?

Sir David Varney: That is really a political decision. Lord Carter must be thinking about that and the Chancellor must be thinking about what his reaction is going to be.

Q111 Mr Bacon: Let me rephrase it. When would you be in a position to switch off the paper return facility?

Sir David Varney: As soon as we have a system which we are convinced is robust and can deal with the volumes and can produce on both sides the sort of data that we can both rely on.

Q112 Mr Bacon: When?

Sir David Varney: We are quite encouraged with what we have seen so far in terms of preparation; we shall now have to put it to the test.

Q113 Mr Bacon: But in terms of timetables ahead. Would you be in a position to do this in one year, three years, five years' time or what?

Sir David Varney: Once we have worked out whether the taxonomy we have works, we shall also be talking to British industry about how fast they can adapt to it—it is not just a straight switch exercise—then, as we see, as with the self-assessment electronic returns, an increase and we get to the point where we have two systems, a more expensive paper system and a much more cost-competitive electronic system, then we shall want to move as fast as we can into the electronic world. There are issues around people, as you will know better than I do, who are not into that electronic world and then how you deal with the people who are excluded.

Q114 Chairman: Well it seems to have been a very useful inquiry by the National Audit Office which I am sure has helped you. Undoubtedly at present your chances of being investigated apparently do depend on where you live in the country and apparently not all your staff historically have been located in the right place. If we can bring up the level of service of the worst-performing areas to the best, then we might raise tens of millions of pounds. We shall try to help you to do that.

Sir David Varney: That is a positive note on which to end.

Chairman: Thank you very much Sir David.

 Supplementary memorandum submitted by HM Revenue and Customs

Qq 83–84 (also refers to Q37) (Mr Ian Davidson): Random Enquiry Programme

Referring to the Random Enquiry programme which detected errors by companies in around 40% of returns, the Committee (Mr Davidson) asked for a breakdown of those errors between cases where extra tax and cases where less tax was found to be due.

The CT random enquiry programme records the yield resulting from HMRC enquiries. The yield recorded in an enquiry case is the change in tax liability in HMRC's favour. Where the net change in tax liability is in the taxpayer's favour a nil yield result is recorded. These cases are included in the 60% of enquiries where no errors were detected. The 40% or so cases where errors were detected are cases where there was an enquiry yield in HMRC's favour.

The yield is calculated taking into account all of the adjustments to the tax return in HMRC favour and in the taxpayer favour.

Adjustments to the tax return(s) as a result of the enquiry are recorded by area of risk and whether these are taxpayer favour or HMRC favour. However no analysis detailing the exact taxpayer and HMRC favour adjustments is currently available and would take some time to produce.

The CT random enquiry programme selects a constant proportion of cases for enquiry. In 2000, the first full year of the programme, slightly under 300 cases were selected. Since then the number of companies has been increasing such that by 2005 the number of cases selected was a little over 400 (This is the figure referred to by Mr Banyard at Q37).

Not all cases selected for the programme are actually taken up for enquiry.

The main reasons for this are:

- the company is dormant,
- is struck off,
- or has been the subject of a separate recent enquiry.

Because of this the results of the programme are based on lower numbers of cases: the analysis of the first three years was based on 421 completed enquiries (the 400 figure referred to in paragraph 2.11 of the C&AG's Report), and 62 enquiries that were underway but not completed.