

TAXREP 36/06

HMRC Annual Accounts 2005 – 06 Evidence to Treasury Sub-Committee of the House of Commons

Written evidence submitted in November 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the Treasury Sub-Committee of the House of Commons in response to a call for evidence

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FOREWORD

1. The Treasury Sub-Committee held evidence sessions on the departmental annual reports of HM Treasury, the Government Actuary's Department, the Royal Mint, HM Revenue and Customs and the Debt Management Office. Brief submissions in advance of any of these evidence sessions were welcomed by the Sub-Committee and the Tax Faculty submitted written evidence on the 2005-06 Annual Accounts of HM Revenue & Customs.
- 2.
3. The evidence covered the three main topics highlighted in the report to Parliament on the 2005-06 HMRC Annual Accounts by the National Audit Office (The Comptroller and Auditor General), namely tax credits, PAYE and MTIC Fraud.
4. The text of the written evidence prepared for and submitted to the Committee is reproduced below.

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TEXT OF WRITTEN SUBMISSION

EXECUTIVE SUMMARY

Availability of the annual accounts on HMRC website

1. [Not reproduced,]

Missing Trader Intra Community Fraud

2. Missing Trader Intra-Community Fraud (MTIC) is the most serious criminal attack on the VAT system since its introduction.
3. We have been critical of the actions taken by HMRC to counter MTIC fraud where they penalise the innocent rather than the guilty, though we recognise that trading in goods susceptible to this fraud is a high risk area and everyone should exercise extreme caution before becoming involved. As we have seen, disproportionate measures risk leading to litigation with innocent businesses, when all efforts should be spent in combating the fraudsters themselves.
 - We welcome the proposed reverse charge but we are concerned that the fraud will switch to other goods and services, and that its intended implementation has been ‘gold plated’. We also believe the current proposals should be amended to prevent them causing unnecessary compliance costs for many UK businesses far removed from the fraud itself.
 - We recommend a further measure which would also counter the fraud. The introduction of a credit limit for input tax which would require businesses to notify HMRC in advance of making abnormal input VAT claims. This would deter the middlemen from becoming involved in the trade.
 - We believe that the only real solution is the (re)introduction of the charging of VAT on cross-border supplies within the EU, which would ‘close the gap’. Whilst we are aware of the political objections, operationally we see the origin system, described in the main Missing Trader and Intra-Community Fraud section below, as the longer-term solution most likely to curtail the fraud.

PAYE System

4. We believe the Government should be considering radical reforms to the PAYE system and in our comments on the HM Treasury Discussion Paper Small companies, the self employed and the tax system, published in December 2004, we put forward the suggestion of a State Employment Service to which employers, pension providers

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and employees could sign up. The service would act as an effective portal which would deal with all the PAYE requirements for the individuals involved. The proposal is described in the Detailed Comments section below.

Tax Credits

5. The Auditor General's report on HMRC's 2005-06 accounts highlights three areas of concern: attacks on the tax credits system, tax credits overpayments, and tax credit error and fraud.

- **Attacks on the tax credits system:** We understand of course that HMRC must protect the integrity of the tax credits system and combat organised crime. We are not in a position to comment on the nature or size of the risk or the measures HMRC are taking to combat it.

However, we are concerned about the effect the continued unavailability of the online service will have on claimants. This is particularly important as the new requirements to notify changes of circumstances mean that claimants have more things to report in a tighter timescale. HMRC must ensure they offer claimants a range of communication methods which best suit their needs, including the ability to notify changes or ask questions by email.

- **Tax credit overpayments:** The ICAEW broadly welcomed the measures announced by the Government on 5 December 2005. These are being introduced in accordance with the planned timetable although it is too early yet to say to what extent they have reduced overpayments. As noted in the report of the Auditor General, this will only become apparent in 2008 once 2006/07 awards have been finalised.

We commented in detail on the 5 December 2005 measures and the problems of overpayments in our evidence to the Treasury Sub-Committee enquiry into the administration of tax credits, but we would like to comment specifically on one of these proposals. We do not support reducing the time allowed for mandatory reporting of changes in circumstances from three months to one month. While we can see that quicker reporting should help to avoid overpayments, we are concerned that this requirement may prove onerous and unrealistic for many claimants.

We are also concerned that the new rule whereby changes can be notified within a month of the claimant 'first becomes aware of the change' (if this is later than one month from the change itself) will give rise to problems of interpretation in practice.

- **Tax credit fraud and error:** This is clearly an area where HMRC needs to do more and better research into the scale of the problem, beyond the research they have already done based on 2003/04 awards and enquiries. and no doubt the Committee will be questioning the HMRC representatives on its plans in this area.

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DETAILED COMMENTS

MISSING TRADER INTRA-COMMUNITY FRAUD

6. Missing Trader Intra-Community Fraud (MTIC) is clearly the most serious criminal attack on the VAT system since its introduction. The opportunity was created by the Single Market VAT changes from 1 January 1993, which removed VAT from intra-Community transactions between taxable persons. The dangers were well-known to tax authorities, including the UK, at that time, so the present position is somewhat self-inflicted.
7. It is difficult to estimate the extent of the fraud, although unofficial estimates for the current year range between £5-8 billion, with the official Government estimate due to be announced in the Pre-Budget Report.
8. We have been pleased to work with HMRC in their campaign warning businesses of the danger signs (so that they do not inadvertently become involved with the fraud) and have highlighted this aspect in our communications with our members. We welcome recent press reports of a significant number of arrests of alleged perpetrators.

The proposed reverse charge

9. We welcomed the proposed introduction of the domestic reverse charge for certain goods, although we see this very much as a temporary ameliorating measure rather than a cure. Our main concerns are that the fraud will simply switch to other goods and services not covered by the reverse charge provisions, and that the proposed rules are 'gold plating' and place an excessive burden on too many businesses. We set out these concerns in detail in our TAXREP 13/06 on the Finance (No 2) Bill 2006, copied to the Committee. Further copies are accessible at our website at <http://www.icaew.co.uk/index.cfm?route=135941>
10. The reverse charge measures require the approval of the Commission and the Member States. Whilst the Commission have approved for their part, we understand that some Member States are not prepared to agree, so the introduction of the provision (originally expected for 1 December 2006) has been delayed indefinitely.
11. Whilst unfortunate, the delay will give HMRC further time in which to address some of the operational issues, such as:
 - the £1,000 *de minimis* limit on transactions. Since, from reported cases, the normal size of transactions involved in the fraud is in tens of thousands of pounds, we question whether such a low limit is appropriate, since it will affect (as a purchaser) the vast majority of businesses in the country.
 - HMRC have yet to provide a definitive list of the goods to be covered by the reverse charge, although the UK's request to the European Commission was made in January 2006.

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- We consider that genuine retailers should be excluded from the new reverse charge where they supply goods to another taxable person. It would be difficult for fraudsters to carry out MTIC fraud using a retail business.

12. At a time when there are many calls for simplicity in the tax system, the detailed reverse charge provisions will add considerable cost and complexity to the VAT accounting for large numbers of UK businesses who have nothing to do with the fraud. Businesses affected also need time to amend their computer accounting systems, and the eight weeks proposed by HMRC is unlikely to be sufficient.

A possible input tax 'credit limit'

13. Once a business is VAT registered, it can recover all the VAT it incurs on its costs without restriction, subject to the normal rules. One feature in reported court cases is that relatively small businesses, innocent or otherwise but part of a fraudulent supply chain, have claimed input VAT on purchases greatly in excess of their historic trading levels. The first HMRC know of this is when the VAT return is submitted, often a couple of months after the event.
14. A credit limit would impose a monetary restriction on the input tax that each VAT-registered business could claim in an accounting period. It would be set at an amount that in the normal course of events the business would not reach, with a fast clearance procedure for businesses to apply for an increase for abnormal transactions, such as a property purchase. The purpose would be to restrict the willingness of 'middlemen' (innocent or otherwise) to become involved and thus reduce the scope of the fraudster to sell the goods and charge VAT. If the middleman knew that he would not be able to recover the VAT automatically through his VAT return, but at best would face a lengthy enquiry from HMRC for exceeding his credit limit, he would be unwilling to enter into the deal. It would, however, require HMRC to be both prompt and efficient in dealing with requests for an increase; otherwise they would be in breach of EC law.

The 'origin system'

15. This is a much longer term solution, and was favoured by the Commission when the current system, not charging VAT in the country from which the goods are despatched, was introduced in 1993. In its classic form, an origin system would mean that a business selling goods to another business in another Member State would charge VAT in the same way and at the same rate as if it were a domestic transaction. The purchaser would then be able to recover that VAT through his own VAT Return, which may require Member States to have a clearing system between them to deal with the money flows, though this would be a political rather than a fiscal requirement. Whilst from an operational viewpoint it would stop MTIC fraud, it would require Member States firstly to set up new systems to exchange information and make refunds to businesses promptly, and secondly it would need to be proof against other possibilities of fraud. An origin system that required businesses to account for output tax on intra-EC supplies, whilst not permitting prompt input tax deduction, would have a negative effect on cross-border trade, and could be seen as discriminatory. Whilst we are aware of the political objections, operationally we see the origin system as the longer-term solution most likely to curtail the fraud.

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PAYE SYSTEM

16. Para 6.10 and 6.11 of the Statement on Internal Control in the 2005-06 HMRC accounts states:

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

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

17. The PAYE system has continued largely unchanged in principle since it was first introduced. As a result it has not sought to adapt to reflect modern working practices.

Multiple sources of earned income

18. The results of the Government's Administration Burdens Reduction Project have identified a number of instances where the existing system fails to cope with modern working practices. Volume 1 of the KPMG report into business burdens (see <http://www.hmrc.gov.uk/news/admin-burdens.pdf>) estimates that there are about 17 million employees and an estimated 50 million employments in the UK. Paragraph 3.1 in Part 3 of the Auditor General on the HMRC 2005-06 accounts puts the figure of separate employments and pensions at 41 million. There are likely to be a number of reasons for this apparent discrepancy.
19. 1. Multiple employments. It is common for individuals to have more than one permanent job at the same time. A cleaner may work an early shift for one company, in the afternoon for another and then work an evening shift for a third unrelated different company. The PAYE system is not sufficiently responsive in such situations to collect the right amount of tax. Let us suppose that the individual earns £5,000 per annum from each employment.
20. In this illustration, three PAYE codes would be issued. A variety of permutations is possible:
- If these are three separate 503L codes, a serious underpayment of tax will quickly arise at the rate of around £100 per month. A person on this level of income can ill afford the cash flow consequences of paying back even hundreds of pounds in tax.

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- If the employers are sufficiently methodical to follow the correct P46 procedure when employments 2 and 3 begin, the individual may find himself with a 503L code from the first employment and a BR code for each of the others. This will mean that basic rate tax is collected from employments 2 and 3, but without any benefit being obtained for the lower rate tax band. An overpayment of tax will arise during the year of approximately £250. Once again a person on a low income can ill afford such cash flow consequences.
- There is a solution under the PAYE system, splitting the tax code between the three jobs, but this usually takes time, knowledge and persistence to achieve. As such employees are unlikely to have an accountant to advise them, it is unlikely that they would know to ask HMRC to do this. Furthermore, if the person gives up one of the jobs, they will then be back to overpaying tax because 1/3 of the personal allowance is no longer being used.

21. 2. Casual staff. The administration required to take temporary staff onto the payroll for only short periods leads many employers to bring such employees onto the payroll as if they are permanent staff. They are then paid only when they work. A nil payslip is produced for other months. The P60 and year end paperwork will need to be produced as for real full time staff. In the catering industry, for example, a casual waiter will usually sign on with a number of agencies. Similarly it is common for healthcare professionals to be apparently employed by more than one employer simultaneously.
22. 3. Pensioners. This is an extension of 1 above. Many widows and widowers will have more than one pension source. It is quite normal to have one pension from the person's own previous employment, another pension from the deceased spouse's previous employment as well as the State pension. Others may receive a pension and also be in employment. The State pension cannot be paid through the PAYE system at all and is always taxed by adjusting the PAYE code or under self assessment if the person has no PAYE source of income. The other two pensions must be paid separately through separate payrolls. This will almost always cause an under or overpayment of tax (see multiple employments above), but especially where the person's total income exceeds the abatement ceiling (£24,594 for a single person in 2006/07).
23. Clearly, a system which is designed around the proposition that everyone has a single job is going to struggle to work properly

Proposed solution

24. We have previously suggested in our response, TAXREP 22/05, to the consultation [Small companies, the self-employed and the tax system](#), published by the Treasury at the time of the Pre-Budget Report 2004, that a state employment service (SES) could be used to deal with these problems.

Illustration

25. Angie, Betty and Cathy each work between 15 and 25 hours a week for the Red Lion pub. Cathy also works for an outside catering company, BBQ Ltd, which is

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unconnected with the pub. The landlord knows that he can afford to employ people as long as his total cost per hour per employee is £6.00. BBQ Ltd knows that it can afford to employ people as long as the total cost per hour per employee is £7.50.

26. Arthur is a pensioner who receives each year an old age pension, an NHS pension and an occupational pension.
27. Let us suppose that the Government sets up an SES. The system could be state funded, or participating employers could pay a small fee. Each individual's details could be transacted by a central agency with payments handled by a single entity or there could be multiple, competing, agencies to provide the facility.
28. Any employer or pension provider can register to use the scheme. Any employee can also register to use the scheme. Each participant is given a registration number, which could be the NI number for the individuals. We note that large employers, if they also came on to such a system, would suffer cash flow disadvantages as they currently deduct tax and NIC and don't have to pay it over before the 19th of the following month.
29. In our illustration, all the above are registered with the scheme.
30. Each pay period, weekly or monthly, the landlord of the Red Lion, BBQ Ltd, the Government pension, the NHS pension and the occupational pension pay the salaries/pensions to the SES. The SES runs the payroll and makes a single net payment to each of the individuals.
31. Benefits: The two small businesses are relieved of all tax calculations, including the consideration of employers' NIC. They each know exactly how much buying one extra hour of labour will cost them. BBQ Ltd does not have to keep completing forms P45/P46 as it uses casual staff. In cases where there was doubt over whether a worker was employed or self employed, normal rules would apply, although they could ask the Revenue for assistance as they do now.
32. Employees with multiple employments and pension sources receive the correct net income without endless wrangling with HMRC over tax codes for different sources of income.

Use of the PAYE system as an alternative to self assessment

33. We have seen a deliberate policy to take as many people as possible out of self assessment with the result that the PAYE system is used as an alternative. For example, where the individual has other sources of untaxed income, such as from rented property, or where there is a higher rate tax liability on savings income, the amount of such income is estimated and then an adjustment is made to the person's PAYE code. In many cases this results in a negative figure for tax free income and hence a 'K code'.
34. PAYE codes are not easy for the public to understand and in particular, the notion of K codes, and adjustments to collect underpaid tax from previous years, are

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notoriously difficult to comprehend. When the system is extended to collect tax on current sources of non-employment income, it simply increases the probability of non-comprehension by the taxpayer, so placing the burden of identifying tax under or overpaid solely onto HMRC.

Concurrent Self employment and employment

35. It has become common for people to start up small businesses whilst remaining employed. E-Bay trading and car boot sales are popular ways of earning extra money. We have seen the PAYE system being used to collect tax on such sources of self employment income, as for investment income above.
36. We would also like to add that in this last case, collecting tax using the PAYE system rather than the self assessment system accelerates its payment by many months. Although the taxpayer can object to this, it does pre-suppose that he can understand what is happening in the first place.

TAX CREDITS

37. The ICAEW submitted both written and oral evidence to the Treasury Sub-Committee enquiry into the administration of tax credits (Sixth Report of Session 2005-06). We are active participants in HMRC's tax credit consultation groups.
38. This is an appropriate time to reflect on the system of Child and Working Tax Credits, and on the problems identified with the system and progress in tackling them. It is nearly a year since the 2005 Pre-Budget Report (5 December 2005) when the Paymaster General announced a package of proposals designed to improve the tax credits system and address overpayment problems. These changes are in the process of being rolled out. It is also nearly a year since the tax credit e-portal was closed (on 2 December 2005) due to its vulnerability to fraud, and regrettably it remains closed with no signs of it re-opening.
39. The Auditor General's report on HMRC's 2005-06 accounts highlighted three areas of concern to do with tax credits: attacks on the tax credits system, tax credits overpayments, and tax credit error and fraud. We comment on each in turn, with reference to the comments we made at the time of the Sub-Committee's enquiry into tax credit administration and to subsequent developments.

Attacks on the tax credits system

40. We understand of course that HMRC must protect the integrity of the tax credits system and combat organised crime. We are not in a position to comment on the nature or size of the risk or the measures HMRC are taking to combat it.

Problems arising from closure of the e-portal

41. However, the loss of the online service removes one of the main ways in which it was envisaged that tax credit claimants would communicate with HMRC. In our view HMRC should do more to inform claimants and their advisers of what is happening

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with the e-portal and to provide alternative routes for claimants to communicate with HMRC.

42. We note that the message on the HMRC website still describes the e-portal as 'temporarily closed', which is misleading and unhelpful since it has been closed for nearly a year. There is currently no indication of when it might re-open.
43. The reduction (from 6 April 2007) in the time allowed to report changes of circumstance from three months to one month, plus the increase (from 1 November 2006) in the number of changes which must be reported, will require claimants to have more contact with HMRC than they do at the moment, as there will be more things to report within a tighter timescale. It is therefore incumbent on HMRC to provide claimants with a range of user-friendly ways to do this, which best suit the needs of the claimant.
44. Alternative routes for contacting HMRC, which they suggest in their publications, are the Tax Credits Helpline and post. However, many claimants would prefer face to face contact. Although this is offered by HMRC, we are concerned that the re-design of the system at Tax Enquiry Centres should not affect people's ability to obtain face-to-face advice when they need it.
45. It is likely that many claimants would prefer email as a means of communication, and we strongly recommend that HMRC should offer email as a way to notify changes or ask questions about tax credits. It should be noted that HMRC already offer such a service for Child Benefit. We understand that HMRC are reviewing their policy on email communication generally, but that there are no plans to introduce this in the meantime specifically for tax credits.
46. We also have concerns about the post as a method of contact, as experience shows that there are often long delays in dealing with post at the Tax Credits Office. One difficulty is that the volume of post at that office makes it hard to spot urgent items; one solution would be to provide a specific form for notifying changes, which could be easily spotted.

Tax credit overpayments

47. The ICAEW broadly welcomed the measures announced by the Government on 5 December 2005. These are being introduced in accordance with the planned timetable although it is too early yet to say to what extent they have reduced overpayments. As noted in the report of the Auditor General, this will only become apparent in 2008 once 2006/07 awards have been finalised.

Notifying changes within one month

48. We would like to comment specifically on one of the December 2005 proposals. We do not support the proposal to reduce the time allowed for mandatory reporting of changes in circumstances from three months to one month. The regulations to achieve this are already in place in the Tax Credits (Claims and Notifications) (Amendment) Regulations 2006, SI 2006/2689.

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49. While we can see that quicker reporting should help to avoid overpayments, we are concerned that this requirement may prove onerous and unrealistic for many claimants. There is a balance to be struck between making the system responsive but at the same time ensuring that the requirements it imposes on claimants are not so onerous that it becomes a burden to them.
50. For some changes of circumstances, one month will be too short a time for reporting because it is difficult to pinpoint exactly when they have occurred or because it is impossible to know within one month if there has actually been a change. To address this issue and in response to concerns expressed by representative bodies, the regulations now include a rule whereby changes can be notified within a month of the claimant 'first becomes aware of the change' (reg 5(b), SI 2006/2689) if that is later than the date of the change. This is intended to provide a solution to some of these practical problems but it does introduce into the procedures a new date which may itself be hard to pinpoint – the date when the claimant became aware of the change. Our concern is that in a penalty situation, HMRC should not interpret this provision as meaning the date when they think the claimant should have realised that a change had taken place.
51. We have prepared a more detailed briefing which sets out our concerns about the new measures on changes of circumstance which we will very happily make available to the Committee if required.

Tax credit fraud and error

52. This is clearly an area where HMRC needs to carry out more, and better, research into the scale of the problem, beyond the research they have already done based on 2003/04 awards and enquiries. No doubt the Committee will be questioning the HMRC representatives on its plans in this area.

Right of appeal and judicial review

53. As set out in our evidence to the Sub-Committee in December 2005, our view is that there should be a right of appeal against a decision by HMRC to recover a tax credit overpayment.
54. We also consider that claimants' access to justice would be improved if the tax tribunals had a judicial review function and could consider HMRC's decisions on matters of tax and tax credits administration. In this context we are pleased to note that the draft Tribunals, Courts and Enforcement Bill provides judicial review powers for the Second-Tier tribunal under the planned new structure. We would also advocate providing such a power for the First-Tier tax tribunals.