

# Protecting tax revenues

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## Executive summary

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Protecting tax revenues against fraud and artificial avoidance schemes is essential if the tax system is to support the Government's wider economic and social objectives. The vast majority seek to contribute their fair share towards funding public services. However, the minority who don't put pressure on the public finances, and impose costs, including higher taxes, on others that undermine fairness and economic performance.

The Government is committed to ensuring the tax system operates fairly and effectively. It has set this as a priority alongside the need to encourage work and enterprise and reduce administrative burdens. The approach taken, which is analysis based and both balanced and comprehensive, is at the forefront of international efforts to protect revenue.

At the start of the decade the UK was broadly in line with other developed countries in its 'tax gap' from non-compliance and avoidance. The measures taken have already reduced annual underpayments of tax by over £5 billion, equivalent to over 1 per cent of tax revenue, compared to five years ago. There have been notable successes, such as a halving of excise fraud, a more rapid response to artificial avoidance schemes, and substantial recoveries of tax from initiatives like the offshore disclosure arrangements.

An important element has been supporting those who want to comply, including working closely with large businesses, measures to reduce administrative burdens and new support tools such as on-line filing. This has not only reduced errors but also reduced costs for taxpayers.

However, economic and social changes are creating new risks to revenue collection. The Government is determined to continue to challenge those who try to reduce their tax payments in an unfair way, and to support those who seek to comply. Revenue protection to enable public services to be funded through lower taxes for the majority of taxpayers will remain a priority alongside simplification and supporting economic performance.

Budget 2008 contains important measures that support this aim. Legislation will be included in Finance Bill 2008 to close avoidance schemes set to cost about £1 billion a year, and to modernise HM Revenue & Custom's (HMRC's) processes for checking compliance, collecting tax and imposing penalties to support a more flexible approach to compliance work.

Following the Comprehensive Spending Review, HMRC has been set an objective for the next three years to reduce further the loss of tax revenue from fraud, error and avoidance, along with objectives to reduce administrative burdens and improve customers' experience. This is being taken forward through a customer-focused strategy based on support, prevention, and tackling those who try to obtain an unfair advantage.

# Chapter I. Why protecting tax revenues matters

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## A fair and effective tax system

**1.1** The Government's objectives are a strong and growing economy based on opportunity for all and a fair society in which everyone shares in rising national prosperity. This requires a modern tax system that encourages work and savings, keeps pace with business developments and globalisation and supports the provision of public services.

**1.2** For such a system to be effective, it needs to operate fairly and effectively. Those who attempt to pay less than their fair share through fraud or by undertaking artificial avoidance schemes undermine the ability of the tax system to deliver these objectives and also impose significant costs. The Government is committed to supporting those who seek to pay their fair share and to deterring and challenging those who do not.

**1.3** This document sets out:

- why protecting tax revenues matters;
- the comprehensive measures the Government has taken to ensure the tax system operates fairly and effectively that have already reduced underpayments of tax by over £5 billion a year; and
- how the Government is responding to new challenges by strengthening further its strategy, including through HMRC plans for improving tax collection over the next three years following the Comprehensive Spending Review.

## Protecting tax revenues

### The challenge of protecting revenues

**1.4** Most taxpayers comply with their tax obligations as far as they are able. HMRC receives a high level of co-operation from businesses, professional advisers and individual taxpayers to help the tax system run smoothly. HMRC will collect the great bulk of the £450 billion it will receive this year through its standard processes of assessment and payment.

**1.5** However, some do not readily pay the tax that they should. This reflects a variety of behaviours. In some cases it is a result of errors or lack of care by taxpayers who do not fully understand tax rules. Some use highly artificial avoidance schemes to reduce tax payments. A small minority deliberately set out to evade their obligations or to profit by fraudulently obtaining tax repayments.

### The cost of underpayments

**1.6** Such behaviours pose a significant threat to the integrity of the tax system and to the delivery of the Government's objectives, contributing to:

- **a significant shortfall in revenue – a 'tax gap'**, requiring tax rates to be higher than they would otherwise need to be to fund public services;

## The Government's approach

- **greater costs for other individuals and businesses**, eroding the principle of fairness that underpins the tax system. Not only do they face higher tax rates, they may also incur extra compliance costs because of the need for broad measures to protect revenues;
- **worse economic performance**, from the need for higher tax rates to make good the revenue shortfall, the competitive disadvantage that efficient taxpaying businesses can suffer and the skilled resources diverted to devising and countering schemes to avoid or evade taxes; and
- **damage to other Government aims**, including reducing harm to health, society and the environment from duties on tobacco, alcohol and fuel.

**1.7** It is against this background that the Government has developed a modern and systematic approach to protecting tax revenues. This is based on a number of principles. The approach is:

- **balanced**, involving both support for those who want to pay their fair share and vigorous action to protect revenues; and considering revenue protection alongside other priorities, such as simplifying tax administration and encouraging work and enterprise;
- **evidence-based**, using analysis to build up an understanding of the nature and drivers of non-compliance;
- **comprehensive**, including legislative changes to improve the structure of the tax system and new operational approaches to make the system less vulnerable while minimising burdens on taxpayers; and
- **performance-based**, with HMRC being set targets for reducing underpayments as a central part of their performance framework.

**1.8** This approach is in line with the best practice recommended by the OECD for identifying and prioritizing tax risks and developing strategies to counter them<sup>1</sup>.

**1.9** The next two chapters consider in more detail how this approach has been implemented so far and how it is being further developed.

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<sup>1</sup> *Compliance Risk Management: Managing and Improving Tax Compliance*, OECD Committee on Fiscal Affairs (2004).

## Chapter 2. Protecting tax revenues: progress so far

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**2.1** This chapter provides more detail of the Government's approach. In particular, it describes HMRC work on analysing the tax gap, which has been used as the basis for its existing challenging performance targets. It also describes the range of measures that have been taken to deliver these improvements, which have already reduced underpayments substantially over the last five years.

### An evidence and performance based approach

#### Analysis of the tax gap

**2.2** Analysis of the 'tax gap' – the shortfall in revenue as a result of fraud, error and the use of artificial avoidance schemes - and of the impact of legislative and operational measures help to build understanding of tax risks and to develop efficient and effective ways to protect revenue.

**2.3** Such analysis is inevitably difficult and subject to substantial margins of error. High revenue risks often derive from concealment, complex schemes or those operating in the hidden economy. Compliance activities can also have effects on taxpayer behaviour that extend well beyond those directly affected.

**2.4** Few other countries produce and publish estimates of the tax gap. The Swedish tax authority estimated a tax gap for direct and indirect taxes of 8 per cent of tax liabilities in 2000, and has recently updated this to 10 per cent in 2007. The Internal Revenue Service estimated that the tax gap for direct taxes in the US was 14 per cent in 2001<sup>2</sup>.

**2.5** Each year since 2001, HMRC has published, alongside the Pre-Budget Report, estimates of the scale of tax gaps for the main indirect taxes: VAT, tobacco, spirits and oils<sup>3</sup>. Such analysis is much more difficult for direct taxes. However, HMRC has published its assessment of the impact of direct tax compliance measures introduced in recent years. It is also publishing today details of an analysis of the tax gap for direct taxes at the start of the decade.<sup>4</sup>

**2.6** On the basis of this evidence, the *Review of the Revenue Departments (2004)*<sup>5</sup>, led by Gus O'Donnell then Permanent Secretary to the Treasury, assessed that at the start of the 2000s the UK had a tax gap of similar order to other developed countries.

#### Performance targets

**2.7** The Government's objective is to reduce the tax gap so as to reduce the burden on ordinary taxpayers. As well as a comprehensive programme of measures, an important part of this approach was the creation of a single revenue department, HMRC, with specific targets to improve revenue collection.

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<sup>2</sup> *Reducing the Federal Tax Gap*, US Internal Revenue Service (2007).  
*Tax Statistical Yearbook of Sweden*, Swedish Tax Agency (2007).

<sup>3</sup> *Measuring Indirect Tax Losses - 2007* HMRC (October 2007).

<sup>4</sup> *Measuring the 'tax gap' – an update*, HMRC (March 2008).

<sup>5</sup> *Financing Britain's Future, Review of the Revenue Departments*, Cm 6163 (March 2004).

**2.8** HMRC's Public Service Agreement (PSA) for the period up to March 2008 includes an objective to improve the extent by which taxpayers pay the amount of tax due, alongside objectives to improve customer experience and strengthen frontier protection. This is underpinned by specific targets for VAT, excise duties, direct taxes and national insurance contributions (see Box 2.1). These involve in total reducing underpayments by an amount equal to about 2 per cent of tax revenue, compared to the position five years ago.

Box 2.1

#### **HMRC's Public Service Agreement targets: 2005 - 2008**

Improve the extent to which individuals and businesses pay the amount of tax due and receive the credits and payments to which they are entitled:

1. by 2007-08, reduce the scale of VAT losses to no more than 11% of the theoretical liability;
2. by 2007-08:
  - reduce the illicit market share for cigarettes to no more than 13%;
  - reduce the illicit market share for spirits by at least half; and
  - hold illicit market share for oils in England, Scotland and Wales at no more than 2%; and
3. by 2007-08, reduce the underpayment of direct tax and national insurance contributions due by at least £3.5 billion each year.

## **A comprehensive and balanced approach**

### **Strategies to protect revenues**

**2.9** A wide-ranging programme of measures to improve revenue collection has been introduced to support this objective. This has had four key elements:

- legislation, guidance and support plus improvements to the design of basic processes to make it easier for taxpayers to pay the right amount of tax;
- new information requirements plus legislative and operational changes to make avoidance less attractive;
- better targeting of HMRC resources, through improved risk assessment, so that burdens for taxpayers and HMRC costs are reduced, and fraud and artificial avoidance schemes are challenged where they do occur; and
- making the tax system as secure as possible from fraud, including organised criminal activity.

### **Supporting taxpayers to improve compliance**

**2.10** The majority of taxpayers want to pay the right amount of tax at the right time. HMRC has changed the way it operates to make it easier for taxpayers to understand their obligations and hence to reduce errors. By increasing certainty and helping taxpayers to comply it is also helping meet the Government's objectives to reduce administrative burdens and make the UK an attractive environment for business.

## 2.11 Measures taken include:

- a new approach to dealing with the tax affairs of large businesses, through Sir David Varney's Review of Links with Large Business (see Box 2.2). This is based on greater certainty on how transactions will be treated; an efficient risk-based approach; speedy resolution of issues; and clarity through effective consultation and dialogue;
- targets to reduce administrative burdens on business. These should benefit all businesses, with Small and Medium Enterprises (SMEs) potentially having most to gain as the bulk of the burden currently falls on this group;
- the introduction of business support tools and packs to help employers understand and meet their obligations to account for tax and national insurance contributions on employees' wages;
- a programme to deliver better guidance and on-line filing through the internet following Lord Carter's Review of HMRC's Online Services; and
- an improved service for tax agents.

### Box 2.2

#### **Sir David Varney's Review of Links with Large Business**

In 2006, the Government appointed Sir David Varney to undertake a review of the relationship between large business and HMRC. Prior to the review, businesses perceived that 'the Department was inconsistent in the approach adopted'. The review involved consulting over 140 businesses to prioritise their concerns and to develop, alongside business, outcomes and proposals to address them.

The report identified that business wants a relationship based on mutual trust with an appreciation of commercial drivers, resourced by trained and supported staff. The Department wants a relationship based on trust and transparency and a shared commitment to efficient and effective compliance.

Following the Review, HMRC has been implementing a new approach, working closely with businesses to understand better how they manage their tax risks within the wider commercial context in which they operate. Wherever possible, HMRC wants to rely on a customer's application of the law to their business, and on their systems and governance, and to identify and quickly resolve any differences of view.

**2.12** These changes are already beginning to make an impact. Administrative burdens on businesses have already been reduced by £170 million in the targeted areas and further measures to deliver another £56 million have been announced over the last year.

**2.13** The Government's anti-avoidance strategy is designed to change the economics of avoidance to make it less attractive. It aims to achieve greater clarity for those who wish to pay their fair share, but to act more effectively against those who use artificial methods to try to reduce their tax payments.

## **The anti-avoidance strategy**

**2.14** It is based on a range of complementary measures, including:

- a new disclosure regime, introduced in 2004 and subsequently extended and refined, requiring those who design and use avoidance schemes to provide details to HMRC (see Box 2.3);
- a substantial programme of legislative measures to close down avoidance schemes that unfairly reduce tax payment. Many of these have been informed by disclosures. This has been supported by enhanced efforts to make new legislation more robust against avoidance and by the use of new more generic approaches in legislation; and
- enhanced operational activity, including more skilled resources and consistent and targeted use of litigation.

Box 2.3

**The disclosure regime**

In 2004, the Government introduced legislation to require the disclosure of direct tax avoidance schemes involving tax arrangements concerning employment or certain financial products. In 2005 Stamp Duty Land Tax on commercial property was added to the regime; and in 2006 the legislation was widened to cover the whole of Income Tax, Corporation Tax and Capital Gains Tax.

The legislation requires disclosure of a tax scheme when: it will, or might be expected to, enable any person to obtain tax advantage; that tax advantage is, or might be expected to be, the main benefit or one of the main benefits of the scheme; and it is a scheme that falls within any description ('hallmarks') prescribed in the relevant regulations.

In most situations where a disclosure is required it must be made by the scheme 'promoter' within five days of being made available. Upon disclosure, HMRC issues the promoter a reference number to pass to each client that uses the scheme, who in turn must include the number on the tax return. A person who designs and implements his or her own scheme must disclose it within 30 days of it being implemented.

A separate disclosure regime for VAT was also introduced in 2004. This requires businesses with a turnover of at least £600,000 to disclose the use of certain schemes listed in regulations. It also requires businesses with a turnover of at least £10 million to disclose the use of schemes containing one of a number of hallmarks of avoidance described in regulations.

**2.15** The strategy has significantly changed the climate for avoidance, particularly through enabling artificial schemes to be identified and tackled more quickly, and has had a major impact on the incidence of mass-marketed avoidance schemes:

- in all recent Budgets there have been measures that have closed down schemes with a potential annual cost of £1- 1½ billion a year (see Box 2.4 for an example);
- litigation has also had a major impact on certain areas of avoidance; for example following the result of a European Court of Justice hearing that

established the principle of abuse of rights in VAT there has been a sharp drop in marketing of VAT schemes; and

- disclosure has enabled HMRC to track users of schemes and a much greater number are now being defeated by operational challenge.

Box 2.4

### **Dividend stripping**

This scheme involved a financial trader acquiring rights to receive a dividend that had been declared but not paid. The trader did not acquire the shares – the dividend was ‘stripped’ from the shares. The trader claimed a deduction for the cost of the rights to the dividend. Shortly afterwards he disposed of the rights for an amount similar to that paid and claimed the receipt was not chargeable to tax. The commercial result was effectively nil, as the right was bought and sold for a similar amount. However, the trader obtained a tax loss equal to the amount paid to acquire the dividend. All the money remained within the group of which the trader was part. A number of special purpose companies were created for the transactions.

The Government closed this scheme in 2005, within 3 weeks of disclosure, protecting around £1 billion in corporation tax for the Exchequer.

## **Modernising compliance activities**

**2.16** HMRC has also modernised its approach to wider operational compliance activities. The aim has been to make them more focused on those who do not meet their obligations and also more flexible so that they can be better tailored to the circumstances and behaviours of different taxpayers.

**2.17** Changes include:

- a more sophisticated approach to risk assessment and greater use of specialist skills in HMRC’s Large Business Service to focus work more on key risks;
- a new approach to targeting areas and sectors where VAT liabilities are underdeclared;
- new ways of tackling those who operate in the hidden economy or high-risk areas, such as a fraud hotline, collaboration with the Gangmasters Licensing Authority (see Box 2.5), and the new Construction Industry Scheme;
- using third party information to enable better identification of evaders, for example through the offshore disclosure arrangements (see Box 2.6); and
- new teams working across direct and indirect taxes to tackle evasion.

**2.18** These measures have had a substantial impact in improving revenue collection. The operational initiatives to improve direct tax compliance that are being monitored as part of the PSA targets are expected to reduce underpayments this year by about £2½ billion compared to five years ago.

Box 2.5

### **Collaboration with the Gangmasters Licensing Authority (GLA)**

HMRC has worked in partnership with the GLA. The GLA regulates businesses that supply labour for agriculture, horticulture, shellfish gathering and food processing and packaging, to protect vulnerable workers from exploitation. During 2006-07 the GLA and HMRC discovered that at least 40 businesses that applied for a licence should also have been registered for VAT. As a result of this cooperation, those businesses have paid an extra £2 million in VAT, in addition to national insurance and PAYE payments for their 6,000 workers, and corporation tax.

Box 2.6

### **Offshore Disclosure Facility**

Following rulings against a number of major financial institutions, HMRC obtained details of approximately 400,000 offshore bank accounts belonging to people with UK addresses. It estimated that up to 100,000 individuals should have included income and/or interest from these accounts on their tax returns but had not. In April 2007, HMRC launched the Offshore Disclosure Facility, enabling investors with offshore accounts to disclose income and gains not previously included in their returns. Those who notified, made a full disclosure by 26 November and paid the amounts due were able to take advantage of the guaranteed, reduced 10 per cent penalty. HMRC is pursuing those with offshore accounts and tax liabilities who did not come forward under the arrangements. The scheme has so far recovered around £400m in unpaid revenue.

## **Tackling organised fraud**

**2.19** Criminal attacks, often undertaken by organised gangs, are a major threat to tax revenues, particularly for indirect taxes. The Government has responded vigorously with measures both to deter such activity, but also to tackle it effectively when it does occur.

## **Excise duties**

**2.20** Strategies have been launched since 2000 to tackle evasion of excise duty, covering tobacco smuggling; misuse of 'rebated' fuels, such as red diesel and kerosene; and alcohol fraud, particularly the diversion of spirits held in duty 'suspension'.

**2.21** These have involved a range of measures designed to attack the economics of the fraud:

- new ways of identifying duty paid products, such as fiscal marks for cigarettes and tax stamps for spirits;
- strengthened control regimes, for example for suppliers of rebated oils;
- enhanced operational activity, including the use of new technology such as freight x-ray scanners; and
- close co-operation with the industries concerned, including Memoranda of Understanding with alcohol and tobacco manufacturers.

**2.22** These measures have had a substantial impact in reducing excise fraud. Illicit market shares for the main excises have halved since 2000 and this year total receipts are expected to be about £2 billion higher than if fraud had remained at 2000 levels.

## MTIC fraud

**2.23** Missing Trader Intra-Community (MTIC) fraud is a systematic criminal attack on the VAT system that is recognised as a serious problem throughout the EU (see Box 2.7). The Government's strategy for tackling it was strengthened in response to a rapid and large rise in attempted fraud in 2005-06. This targets the people, goods and money flows associated with the fraud using measures including:

- legislation to make traders jointly and severally liable for VAT debts and to change the VAT accounting practice on domestic business-to-business supplies (a 'reverse charge') for the most commonly traded MTIC goods;
- operational activity, including rigorous checks on suspect applications for VAT registration, and the use of dedicated teams to carry out in-depth verification of suspect VAT repayment claims; and
- criminal investigation and prosecution of those involved in the fraud, and the recovery of the proceeds of their crimes.

**2.24** As a result of the strategy, attempted fraud is estimated to have fallen by up to £1½ billion in 2006-07, to between £2¼ billion and £3¼ billion. Trade statistics indicate that the reduction in attempted fraud was sustained in 2007.

Box 2.7

### Missing Trader Intra-Community (MTIC) fraud

In its simplest form, MTIC fraud involves obtaining a VAT registration to acquire goods VAT-free from other EU Member States. The fraudsters then sell on the goods at VAT-inclusive prices and disappear without paying the VAT to HMRC. A more complex form of the fraud involves the same goods circulating repeatedly between and within EU Member States, with the aim of creating large unpaid VAT liabilities and associated fraudulent VAT repayment claims. Such 'carousel' fraud goes beyond evading tax obligations arising from legitimate trading: it is contrived trading for the purpose of stealing VAT. The organised criminal networks behind MTIC frauds are well-resourced, innovative, resilient and known to be involved in wider criminality, including armed robbery, kidnapping and drugs smuggling.

## The impact of revenue protection strategies

**2.25** The comprehensive set of measures that have been adopted have had a major impact in improving revenue protection. In priority areas subject to specific PSA targets – VAT, the main excises, the main direct taxes and NICs – underpayments of tax have already been reduced by over £5 billion a year compared to five years ago, equivalent to over 1 per cent of tax collected by HMRC<sup>6</sup>.

**2.26** The landscape for revenue protection has also substantially changed. The anti-avoidance strategy has enabled artificial avoidance schemes to be identified and tackled more rapidly and effectively. Engagement with taxpayers – including with large businesses following the 2006 Varney Review - has also greatly increased understanding of revenue protection issues amongst taxpayers.

<sup>6</sup> HMRC Departmental Autumn Performance Report (December 2007).

**2.27** Analysis of the extent and drivers of non-compliance has also improved the ability of HMRC to understand taxpayer needs and assess risks and hence put it in a stronger position to identify effective and efficient ways of responding to revenue risks.

## Chapter 3. Protecting tax revenues in future

**3.1** This chapter provides more detail on how the Government is taking forward the approach to protecting tax revenues, building on the previous successful initiatives, to ensure that a modern system of tax administration supports the Government's economic and social objectives. In particular, it covers the approach that HMRC is adopting to deliver its objective to reduce further the tax gap.

### Taking forward the strategy

#### Continuing challenges

**3.2** The improved revenue collection performance, the progress with new ways of working and the stronger analytical base have all created a much firmer basis for revenue protection.

**3.3** But economic and social changes are creating new risks. For example:

- increased mobility and flexibility of economic activities as a result of globalisation and innovations in communications, business structures and financial products are producing new opportunities for those who want to evade or avoid tax; and
- fraudsters are constantly developing new methods to try to circumvent the measures that have been introduced.

#### The Government's objective

**3.4** The Government is determined to continue challenging those taxpayers who do not pay their fair share and to reduce the tax gap further. This will enable public services to be funded with lower taxes on ordinary businesses and individuals than would otherwise be the case. It intends to do this in a way that:

- maintains incentives in the tax system to encourage enterprise and growth; and
- makes the tax system as clear, simple and efficient as possible for the bulk of taxpayers who wish to comply thereby reducing their costs.

#### HMRC's Departmental Strategic Objectives

**3.5** HMRC will have the key role to play in delivering the Government's objective. This is reflected in its Departmental Strategic Objectives (DSOs) for 2008-09 to 2010-11 set out in the 2007 Pre-Budget Report at the conclusion of the Comprehensive Spending Review (see Box 3.1).

HMRC's new performance framework will involve targets to

- increase further the amount of tax due that is actually collected;
- improve customers' experience of dealing with HMRC; and
- reduce administrative burdens on business.

### HMRC's Departmental Strategic Objectives

**DSO1 – Improve the extent to which individuals and businesses pay the tax due and receive the credits and payments to which they are entitled.**

Key outcomes are:

- increase tax and national insurance contributions actually received relative to the amounts that should be received;
- reduce the level of incorrect tax credit payments as a result of error and fraud as a percentage of finalized entitlement; and
- maintain take-up of entitlements to tax credits and child benefit.

**DSO2 – Improve customers' experience of HMRC and improve the UK business environment.**

Key outcomes are:

- improve customers' perception of their experience of dealing with HMRC;
- reduce administrative burdens on business;
- make *Businesslink.gov* the prime online informational and transactional channel for business with government;
- improve the quality of processing in large volume business areas; and
- maintain correctness of advice and information and actions taken in respect of contact from customers.

## Delivering modern and efficient revenue protection

**3.6** The pursuit of these objectives will continue to be guided by the principles of an approach that is **evidence** and **performance** based and is **balanced** and **comprehensive**.

**3.7** HMRC's ambition is to put customers at the heart of everything it does. It aims to enhance the way it interacts with taxpayers through:

- **support:** building services and communications that are tailored to the needs and circumstances of taxpayers;
- **prevention:** ensuring that basic processes and design make the system as secure as possible from fraud and avoidance; and
- **identifying and tackling those who set out to obtain an unfair tax advantage:** using improved risk assessment and checks with sanctions as appropriate that are tailored to behaviour.

**3.8** Existing strategies are being refined and new ones developed. Key elements include:

- greater focus on **taxpayer groups** – with segmentation into large and small business taxpayers, individuals with complex and more straightforward tax affairs, and criminals – to improve the way actions relate to different needs and behaviours. This will facilitate the balancing of revenue protection with maintaining a competitive environment for business;
- better **analysis**, as sophisticated data matching and risk profiling will make more effective use of the information that HMRC already collects as well as third party information. This will improve assessment of risks and the impact of HMRC activities;
- **modernising the legal framework** within which HMRC operates through the review of powers, deterrents and safeguards (see Box 3.2);
- further exploiting the **benefits of an integrated department**, for example, through more cross-tax working and greater consistency of approach, to enhance revenue protection and also reduce costs for taxpayers (see Box 3.9);
- **closer working with the EU and international partners** to address the growing number of revenue protection issues arising as a result of globalisation (see Box 3.3); and
- improving the **skills** available to HMRC, including better understanding of the commercial environment.

Box 3.2

#### **The review of HMRC's powers, deterrents and safeguards**

The review of powers, deterrents and safeguards was launched in 2005. It is designed to provide greater consistency across taxes, a modern framework of law and practice for HMRC, and strong safeguards for taxpayers. It aims to improve HMRC's effectiveness and reduce costs for compliant taxpayers by supporting those who seek to comply and coming down hard on those who seek an unfair advantage.

The first legislative changes as a result of the review, which followed extensive consultation, were enacted in Finance Act 2007:

- a new behaviour based system of penalties for incorrect returns for the main direct taxes and VAT; and
- a new approach to criminal investigation powers based on the Police and Criminal Evidence Act;

Following further consultation, proposals for further changes will be included in Finance Bill 2008:

- a new more flexible approach to 'compliance checks' to ensure that taxpayers declare the right amount of tax. This will involve a wider range of checks more geared to different taxpayers' behaviour;

- extension of the new penalties regime to other taxes and duties; and
- measures to make it easier for taxpayers to pay what they owe on time and to support HMRC in tackling those who pay late.

HMRC is also working with interested parties on the development of a Taxpayers' Charter.

Box 3.3

### **Working with international partners**

The UK participates actively in a number of international initiatives designed to protect revenues and support those who want to comply. These include:

- a study led by HMRC on behalf of the OECD into the role of tax intermediaries in tax systems. The study has been widely welcomed by the tax intermediary community;
- tackling unfair tax practices and promoting transparency and exchange of information around the world, through the OECD and the EU Code of Conduct and Savings Directive;
- working closely with the Tax Commissioners of Australia, Canada, the United States and Japan on a joint task force to identify and curb abusive tax transactions, the Joint International Tax Shelter Information Centre (JITSIC);
- participating in OECD Working Parties, for example on guidelines on how to apply international transfer pricing rules.

HMRC has Fiscal Crime Liaison Officers in strategic locations overseas with responsibility for promoting and coordinating intelligence partnerships with overseas agencies.

HMRC is also actively engaged in discussion with other EU Member States on ways to improve arrangements for information exchange and cooperation between operational teams across Member States on countering MTIC and other forms of VAT fraud.

**3.9** The following sections illustrate how this approach is being taken forward in key areas and how it will be developed further over the period up to 2011.

**3.10** A priority for HMRC is to develop further its relationship with large businesses to improve the UK business environment. The majority of large businesses seek to manage their tax affairs in a responsible way and HMRC will continue to support these. However, the nature of large business operations, which often involve complex international or financial transactions, inevitably creates difficult tax issues and risks. An effective process for managing these risks is needed.

**3.11** Since the publication of the Varney Review in 2006, HMRC has made considerable progress, working closely with the business community, in developing a better and more proportionate approach. HMRC published its *Approach to Compliance*

*Risk Management for Large Business* in 2007. A further update on the Review has been published today<sup>7</sup>.

**3.12** The new approach involves:

- working with businesses and their advisers to identify and mitigate risks of tax loss at an early stage, with new processes for clearances and advance agreements providing greater certainty;
- new ways of managing risk (see Box 3.4), including risk reviews for businesses. These have already resulted in nearly 40 per cent of large businesses being categorised as ‘low risk’ and the closure of three-quarters of ‘low risk’ enquiries;
- engaging directly with the management boards of businesses presenting the highest risks to influence their behaviours. In some cases large teams of technical, investigative and legal experts have been formed to focus on major individual risks;
- a new approach to transfer pricing risks, a high priority area for both HMRC and business. This will be supported by greater use of expertise and new processes and governance, and aims to concentrate effort on the highest risks, apply a more consistent approach and reduce the time taken for a typical case; and
- greater clarity through consultation, better guidance and research on business experience of dealing with HMRC.

Box 3.4

**Managing compliance risks for large businesses**

For low risk businesses there will be:

- risk reviews only every two to three years, or longer ;
- far fewer interventions;
- increased clarity and certainty through real-time working; and
- reduced compliance costs.

For higher risk customers there will be:

- at least annual risk reviews;
- increased emphasis on significant risk;
- more real-time working and speedier resolution; and
- partnership working and support to reduce risks.

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<sup>7</sup> *The framework for a better relationship. Making a difference: Review of Links with Large Business*, HMRC (March 2008).

## Encouraging compliance by SMEs and individual taxpayers

**3.13** The same principles of making processes as simple as possible and strengthening guidance and support tailored to needs are also being applied to dealings with small businesses and individuals. A progress report on HMRC's plans to work better with SMEs has been published today<sup>8</sup>.

**3.14** The new approach involves:

- new customer-focused structures to provide help and guidance to SMEs and individual taxpayers, such as the Targeted Education, Enabling and Leverage (TEEL) national team and local structures focused on particular customer groups;
- a range of new services, including extending to all businesses from April 2008 the non-statutory clearance approach now available to large businesses and offering more flexible payment options such as the option to pay by credit card;
- providing a more varied set of 'compliance checks' tailored to the size and nature of the risk (see Box 3.2) and removing penalties for those who make genuine mistakes despite having taken reasonable care. The use of suspended penalties will provide new incentives for people to take more care with their tax affairs;
- targeted national campaigns and local projects to support specific customer groups. These will use a combination of advertising, collaboration with trade and professional bodies, and large-scale mail or telephone contact. Campaigns are currently planned in a number of key areas, such as construction, Olympics preparation and offshore investment;
- working in partnership with professional advisers, especially accountants, to develop a better understanding of how to eliminate errors and reduce the need for expensive, post-return checks (see Box 3.5); and
- working with the Voluntary and Community Sector to support customers in more vulnerable positions (see Box 3.6).

Box 3.5

### Working with professional advisers

HMRC recognises that many of its customers will not come directly to the Department in the first instance for advice and guidance. Many in the business community look to professional advisers. HMRC is therefore in the process of developing improved communication and access to HMRC services for tax advisers, especially accountants. Several initiatives are currently being trialled, including

- a dedicated agent helpline in telephone contact centres, manned by experienced staff who are able to respond to complex tax queries more quickly;
- agent 'account managers' based in local offices, working with groups of accountants to identify everyday problems that get in the way of basic compliance; and

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<sup>8</sup> *Developing a new relationship with business*, HMRC (March 2008).

- ‘customer relationship managers’ based in large processing offices, to help agents to file returns more easily and accurately.

The process by which agents are authorised to act on behalf of taxpayers in respect of different taxes is also being streamlined.

Box 3.6

### Supporting ‘hard to reach’ customer groups

The Voluntary and Community Sector (VCS) makes an essential contribution to helping people get their tax right. HMRC is funding organisations to carry out work in this area and learn from them how to deliver better services and more useful material to help customer groups in more vulnerable positions. Organisations being supported in this way include:

- The Action Group – helping people with learning disabilities access HMRC products;
- CAB North Liverpool – providing information on HMRC products to newly arrived immigrants;
- Life Academy working with Taxhelp for Older People – Providing tax help to pensioners and pre-pensioners;
- The Prince’s Trust – providing advice and support on HMRC products for young people taking part in the Prince’s Trust Business Programme;

## Responding to avoidance

**3.15** Although the anti-avoidance strategy has had a major impact on marketed schemes, significant risks remain and new challenges are resulting from, for example, increased use of bespoke schemes and multinational restructurings to reduce tax liabilities. These will continue to be tackled through legislation and litigation. However, the Government is also committed to setting anti-avoidance legislation in a framework that is responsive to today’s needs to ensure that the competitiveness of the UK is maintained.

**3.16** Key elements of the strategy will be:

- continuing to monitor the disclosure regime, taking action as necessary to ensure it remains effective in enabling a rapid response to new avoidance risks. Proposals for improvements to the regime will be included in Finance Bill 2008;
- further legislation to close down avoidance schemes. Finance Bill 2008 will include a further package of such measures that will close schemes that were set to cost the Exchequer about £1 billion a year in revenue;
- modernising legislation to ensure revenue protection and greater simplicity. The Anti-Avoidance Simplification Review, launched in the Pre-Budget Report 2007, will have a key role in this (see Box 3.7);
- considering further how best to use the different approaches to anti-avoidance legislation – from specific loophole closing measures to more recent generic approaches, such as targeted anti-avoidance rules and a principles-based approach – to provide both revenue protection and the clarity that is important to taxpayers;

- working closely with international partners, for example through JITSIC (see Box 3.3), to identify and counter avoidance risks that arise from increased globalisation; and
- continuing to challenge the use of artificial avoidance schemes through investigation and litigation.

Box 3.7

### **The Anti-Avoidance Simplification Review**

The objective of the review is to consider how anti-avoidance legislation can best meet the twin aims of simplicity and revenue protection. Its priorities are simplifying areas of existing legislation and ensuring that new anti-avoidance legislation is clear, effective and well targeted.

Following a constructive engagement with business and professional stakeholders<sup>9</sup> it has been announced that:

- proposals to repeal some provisions that no longer protect revenue will be included in Finance Bill 2008; and
- HMRC will conduct reviews into a number of areas of legislation identified as priorities for simplification.

A further progress report will be published with the Pre-Budget Report 2008.

## **Tackling non-compliance**

**3.17** Clamping down on those who try to cheat the system through evading taxes will continue to be a priority. Although existing strategies have had considerable success in suppressing the most blatant forms of fraud, those involved have often adapted their tactics in response to HMRC activities.

**3.18** A comprehensive range of measures will be used to increase the likelihood of detection, develop greater consistency of approach across taxes, and make sanctions better matched to behaviours and more visible to potential evaders.

**3.19** Key elements will be:

- making more effective use of the information the Department holds and third party information to increase the likelihood of detection. This also involves introducing further sophisticated data matching and risk profiling tools to help HMRC focus on the highest risk cases. These are being applied in campaigns to identify undeclared income, such as property income (see Box 3.8);
- developing cross-tax working to investigate and deter suspected evasion (see Box 3.9);
- implementing a new hidden economy strategy to reduce the threat by encouraging individuals into the formal economy. Education and support will highlight the advantages of legitimising activities such as increasing credibility and opening up business opportunities;
- using investigation, litigation and, in appropriate cases, legislative changes to respond to new forms of tax risk. HMRC's Litigation and Settlement Strategy

<sup>9</sup> A progress report on the anti-avoidance simplification review: simplifying anti-avoidance legislation, HMRC (March 2008).

was published in 2007, focusing on the recovery of the full amount of tax at risk in material cases where HMRC believes it has a strong legal case;

- applying new penalties for deliberate understatement in returns from April 2009. These will be consistent across the main taxes, more visible and more clearly linked to behaviour; and
- frustrating the activities of organised criminal gangs by collaborating with other organisations and law enforcement agencies and making HMRC's processes and systems more secure against fraud. Additional resources are also being deployed by HMRC on criminal investigation, to underpin all tax regimes.

Box 3.8

### **Using information to target tax risks**

Through investment in technology already used in the financial services and credit industry, HMRC will be able to join, match, filter and analyse the rich reserves of data held by the Department. In recent months HMRC has joined 37 large datasets in one pilot system for the first time, including Self-Assessment, PAYE and VAT data plus a range of external data. When combined with analytical tools, this has given an unprecedented ability to identify irregularities.

Campaigns to exploit this information will be designed, piloted, deployed and measured by skilled staff including risk experts, experienced operational staff and professional campaign specialists.

One early application is in the **Property Campaign**, which is designed to identify people who have received income from property but have not disclosed it to HMRC. Following on from an advertising campaign, HMRC is sending letters to taxpayers for whom it holds information suggesting that they may have received income from letting property. The letters contain clear guidance, along with a standard form that can be used to return details of income received. Where no reply is received, consideration will be given to further action (which could include formal enquiry or, in exceptional cases, criminal investigation).

Box 3.9

### **Tackling evasion through cross-tax working**

Exploiting the benefits of an integrated Department, tax teams that cover both direct and indirect taxes are being set up in both HMRC local offices and specialist investigation offices to tackle fraudulent activities.

A new, more streamlined system has been established for identifying and referring cases of suspected evasion for possible in-depth investigation wherever they arise and whatever taxes and duties are involved. A centralised team ensures that cases are considered for possible criminal and civil action in a consistent way and are checked against key sources of information. The team is also helping to build a comprehensive picture of evasion to target risks better in the future.

Early indications are that this new integrated approach is helping HMRC to make optimum use of its specialist investigation resources and that it will ensure greater fairness for taxpayers in general.

## Chapter 4. Conclusion

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**4.1** Protecting tax revenues is an essential part of the Government's commitment to prosperity and fairness. Its strategy has delivered a major improvement in revenue collection over the last few years.

**4.2** But in a fast changing social and economic environment the challenges of protecting revenue keep evolving. The strategy also needs to reflect the wide range of behaviours that lead to loss of revenue, from simple error to organised criminal fraud, and to balance the need for protection alongside the importance of a tax system that promotes enterprise and fairness.

**4.3** HMRC's customer focused approach is designed to respond to these challenges. It is aiming to develop strong relationships with its business and individual taxpayers to make it easier for them to comply, and to take into account that tax is only one of the many personal and commercial drivers which impact on them. At the same time it still needs to crack down on fraud and to tackle other forms of non-compliance effectively.

**4.4** HMRC has already strengthened its strategy in key areas, but it will continue to respond to new risks to revenue by developing innovative forms of support, detection and investigation. Understanding and quantifying each problem and its causes, developing a variety of targeted responses, and evaluating the impact of those responses so that adjustments can be made to achieve the right outcome will be key elements going forward.

**4.5** Society and the economy in the UK benefit from the high level of compliance by the great majority of taxpayers, and from the confidence that those deliberately attempting to pay less than their fair share will be dealt with effectively. Protecting tax revenue for the good of all will continue to be a priority for the Government.