

## **Measurement of direct tax gaps**

### The approach

1. A rigorous analysis of the “tax gap” is an essential part of the compliance strategy for HMRC. It is used to understand the compliance issues facing the department and thus to develop strategic initiatives. Since 2001 HMRC has measured and published the scale of tax gaps from VAT (including Missing Trader Inter Community fraud) and the main excises – spirits, tobacco and oils. These gap measures are used as a key indicator of effectiveness and form part of the PSA targets for HMRC.
2. It is more difficult to obtain robust estimates of tax gaps for the direct taxes. For direct taxes there are no independent sources of data describing the taxable income for the various taxpayer populations. Therefore our estimates of revenue losses are derived from information acquired from HMRC compliance activities, whilst further work continues to explore the usefulness of other sources of data. Most compliance work is risk based, and it can be difficult to use the information gained from such enquiries to assess revenue losses from other taxpayers. However HMRC also undertakes random enquiries, the results of which can be used to extrapolate figures for the rest of the population.
3. Other countries that produce estimates of tax gaps mainly do so using the results of random enquiry programmes, notably in the United States. However it is important to remember that the results from random enquiry programmes are not comprehensive. Random enquiries do not detect the full amount of non-compliance. And they are not a suitable measurement tool for some customer groups – most notably large business.

### Progress so far

4. HMRC is committed to producing cross-tax estimates of the tax gap. In October 2007, alongside the Pre Budget Report, HMRC published a technical discussion document called “Developing Methodologies for Measuring Direct Tax Losses”. This document included the first estimates for the direct tax gap for small and medium companies and individuals – largely based on the results of random enquiry exercises.
5. For the first time today HMRC is publishing estimates of revenue losses for large business and from avoidance. Estimating the scale of losses in these areas is not only inherently difficult but also a relatively untested area of work for governments around the world, with only the United States having published work in this area. Therefore the UK is taking a lead and the publication of these figures is a significant step forward. But it is inevitable that these estimates will be subject to periodic change, as improved understanding and new methods become available.

### What do the new figures for Large Business and Avoidance show ?

6. For the largest business it is not practical to use a random enquiry approach because of the huge resource requirement it would place on both HMRC and the

business. However HMRC does carry out regular risk assessments for all large business to identify the key issues where the tax treatment is in doubt. The figures presented today are based upon the data collected from our new management information systems over the past 18 months. This is a rich new source of information that systematically records:-

- for large business the original “tax under consideration” recorded by case workers as they identify issues and the expected recovery from compliance interventions. By comparing one against the other for a particular accounting period it is possible to get HMRC’s view of revenue losses.
- for avoidance outside of large business the tax lost through the use of known avoidance schemes and the expected recovery through intervention.

7. These are new data systems. Therefore these first estimates of revenue losses need to be viewed with some caution as they will inevitably be subject to some revision in the future. Clearly there are issues with calculating losses on the basis of this information. The calculation may overestimate revenue losses as:-

- The Management Information systems were not explicitly designed to measure tax gap. Rather they were designed to record issues that need enquiry or discussion.
- Computation of corporation tax for large business can be extremely complicated and will often depend on the precise application of tax rules and accountancy principles to complex commercial transactions, where there is sometimes no single ‘right answer’. It is not always clear how to define a tax gap in these circumstances. Many of these potential issues identified turn out, on further dialogue with the customer, to be fine.
- Some issues are difficult matters of judgement - for example transfer pricing issues – where there is no clear right answer. In these situations a lot of detailed analysis is required to come to an answer and it will often be the case that the first thoughts of our tax specialists turn out to be too high.

8. Conversely basing estimates of revenue losses on issues identified by HMRC will contain an element of understatement because there will be always be issues that are not identified – the “unknown unknowns”.

9. “Avoidance” itself covers a wide range of activities through highly artificial schemes operating around the margins of legality to schemes that work in law but in an unintended way. Therefore there will be cases where issues where avoidance has been identified but not recorded because it would not be practical to challenge. Nevertheless we believe that where avoidance has been identified it is often straightforward for our tax experts to correctly identify the tax lost through the use of an avoidance device. In making this assessment the department does not expect to collect all the tax at risk identified. Some avoidance will need to be dealt with by legislation for the future only.

10. The figures for large companies, largely based on data for 2004/05 corporation accounts, are shown in table 1

Table 1 – estimates of revenue losses for large business and from avoidance

Customer group	Type of revenue loss	Gross revenue losses	Net revenue losses
Large Business	Avoidance	[£5.5bn]	[£2.9bn] ([11%])
	Transfer Pricing	[£1.2bn]	[£0.8bn] ([3%])
	Other issues	[£3.7bn]	[£1.8bn] ([7%])
Other*	Avoidance	[£3.0bn]	[£1.5bn]

\*Ideally will split between individual and SME for final presentation

11. Table 1 shows:-

- Tax saved through use of avoidance devices running to [£5.5bn]
- Of which we expect to successfully challenge [£2.7bn] through interventions
- Where we do not succeed in challenging avoidance in the courts we try to legislate. However we have not included this effect in these figures since it closes down the issue for the future but does not recover losses from the past.
- An additional [£4.9bn] of losses arises from other issues, of which [£1.2bn] is transfer pricing. We expect to recover [£2.2bn] of this.
- For the largest businesses this gives a total net figure of [£5.5bn] compared to liabilities of around [£20bn.] This indicates a tax gap in the region of [20%].

12. For avoidance outside of the largest businesses:-

- Our annualised estimate of attempted avoidance is [£3bn].
- Of which we expect to successfully challenge [£1.5bn] giving a figure for net revenue losses of [£1.5bn].

### The overall direct tax gap

13. Adding in the estimates for small and medium companies and individuals, gives an overall estimate of £12 billion losses per annum. Given the estimates for small business and individuals are certainly lower bounds it is sensible to also regard this overall figure of £12 billion as a lower bound of the extent of actual revenue losses – which is roughly 5% of all receipts. Table 2 shows how the overall figure is built up.

Table 2 – All estimate of tax gaps and percentage tax gaps contained

Customer group	2001/2	2002/3	2003/4	2004/05
Individuals subject to self-assessment	£2.3bn (12%)	£2.5bn (13%)	-	
Small and Medium-sized employers			£0.8bn (1.2%)	
Small and Medium-sized companies	£1.8bn (14%)	£2.2bn (17%)	£1.7bn (12%)	
Large Companies				[£5.5bn (20%)]
Avoidance outside of large companies*				[£1.6bn]

\* for final presentation we will attempt to place this within customer groups and think about how to handle the different years of analysis.

14. The US estimates that they have a gap amounting to almost 13% of total revenue, while Sweden estimates that it has a gap of 9%. These estimates include some assessment of the impact of the informal economy. This lower bound estimate of 5%, that does not include estimates of losses arising in the informal economy, Inheritance Tax or Stamps Duty Land Tax, is therefore highly plausible in the light of the international work.

15. The overall estimate for indirect taxes comes to roughly £15bn in 2006/07. Caution must be exercised in comparing the estimates for indirect taxes with the estimates shown in table 2. The estimates relate to different points in time. But more importantly they are calculated using a completely different approach. In particular the methodology for calculating the VAT gap produces a central estimate of losses rather than the lower bounds that some of the methods for direct taxes produce.

16. Recent work published by the TUC has suggested revenue losses from avoidance of some £25bn per annum for direct taxes. These figures are calculated on a completely different basis to the analysis described here which makes comparisons difficult. The key to the difference is that the analysis in the TUC report includes a lot of activity that HMRC would regard as perfectly legitimate tax planning rather the use of artificial avoidance schemes. So for example:-

- For wealthy individuals the analysis includes the use of any reliefs and allowances e.g. reliefs for charitable contributions.
- For large companies the analysis computes an effective tax rates for 50 of the large companies, compares this with the maximum tax a company could pay if not claiming any relief or allowances and describes any difference as avoidance. (In fact even the calculation of an effective tax rate for a global company based is extremely difficult to do and depends upon some very strong assumptions, in particular the assumption that deferred tax is not paid).
- For non-domiciles a calculation is used which makes a very strong assumption about the total income of non-domiciles from around the world. It does not comment on the fact that where income has not been remitted to the UK it will have been taxed somewhere, and so would be subject to double tax relief if UK were to remove the remittance basis of calculating tax.

17. Together this means that the overall calculation will produce a much higher estimate of revenue losses from avoidance than HMRC accepts, mainly because it does not differentiate between the legitimate use of tax planning and the use of artificial schemes. Our own analysis of the use of avoidance schemes suggests much lower figures.

### **Earlier estimates from 2005**

18. Today we are also releasing figures relating to earlier work carried out in 2004 and 2005. Table 3 shows the internal estimates made in 2005 of revenue losses by type of tax.

Table 3 –range estimates of net revenue losses in 2005 paper by type of tax (£bn)

Direct Tax	General non-compliance			Avoidance			Non Payment			Total		
	Point	Lower	Upper	Point	Lower	Upper	Point	Lower	Upper	Point	Lower	Upper
<b>Income Tax, CGT, NIC</b>	8.1	3.7	17.1	3.9	1.9	5.9	0.5	0.5	0.5	12.5	6.1	23.4
<b>Corporation Tax</b>	2.9	1.4	6.9	4.4	2.1	6.6	0.2	0.2	0.2	7.2	2.9	13.7
<b>Inheritance Tax</b>	0.5	0.2	1.0	1.5	0.7	2.2	0.0	0.0	0.0	2.0	1.0	3.5
<b>Stamp Duty</b>	0.1	0.1	0.4				0.0	0.0	0.0			

19. Added together the ranges estimates produced a combined range of around £10bn to £40bn with a “best” estimate of £22bn. This compared to receipts of £246bn (tax and NIC) in 2003/04. Note that adding the upper end of ranges produces an extreme answer for the total because it is very unlikely that the real answer for each of these estimates lies at the top end of the range.

20. The width of the ranges shown demonstrates represents both the inherent difficulty involved in estimating the direct tax gap and the very early stage that the methodology had reached. The data available at the time was patchy and therefore many of these estimates are heavily dependent on assumptions. In particular there was very little departmental data available to help with estimates for Avoidance, Large Business, the Informal Economy, Inheritance Tax and Stamp Duty Land Tax. Work since then to develop management information has focussed on the areas where we believed the largest losses may lie – Avoidance and Large Business.

21. It is not straightforward to compare these estimates to our latest estimates of a lower bound of [£12bn] net revenue losses. This estimate is not strictly comparable to the analysis produced in 2005 because:-

- The methodology used to calculate revenue losses from avoidance and Large Business has completely changed since then.
- This latest figures do not include anything for Informal Economy, Inheritance Tax and Stamp Duty Land Tax where work is still progressing to produce robust estimates of revenue losses.
- In the latest analysis no conjecture is made to the extent to which random enquiries do not detect non-compliance. We now believe that without hard evidence it is not helpful to make such an adjustment.

### **The figures for avoidance in the 2005 document**

22. The work described in the 2005 paper represented a first attempt to get a broad handle on the scale of avoidance. There were two strands of work. The first strand obtained information from HMRC in the course of case work and mainly focussed on activities that were potentially challengeable. This led to a lower limit of £5bn revenue losses per annum. The second strand was based upon an analysis of amounts paid to the top 50 agents for tax related work as described in Accountancy Age. This method will pick up activities not identified by HMRC case workers and as well as

broader avoidance activities that were clearly within the law. This analysis of fees produced an estimate with a range of £5-15bn revenue losses per annum. In practice the upper limit is likely to include a significant element of tax planning.

23. The width of the range results from the speculative nature of this method of calculating revenue losses. Hence we do not have a lot of faith in this method, other than as a very broad credibility check of internal analysis.