

# Tax Gap for the Very Wealthy

## 1. Issue

This paper estimates the tax gap for the very wealthy through analysis of Complex Personal Returns (CPR) risk based enquiries. Analysis has also been undertaken to identify the main tax risks associated with the wealthy. For the purpose of this analysis, wealthy has been defined as the 40000 taxpayers falling within the remit of CPR teams. These taxpayers are selected by having substantial income or wealth, and complex tax affairs. Based on this definition, the tax gap for the very wealthy is estimated to fall within a range from £115m to £250m.

## 2. Background

Currently, the department has an overall measure of the tax gap for the wealthy covering all non-business SA taxpayers, approximately 4.8m taxpayers. The wealthy tax gap was calculated from pooled results for the ITSA Random Enquiry Programmes for 1999/2000 and 2000/2001. The point estimate of the gross tax gap is £0.8bn within a range of £0.4bn to £1.5bn. Taking out compliance yield this gives a net gap of £0.5bn within a range of £0.2bn to £1.3bn <sup>1</sup>. This paper is a first step analysing the very wealthy segment as a component of the overall wealthy estimate. It builds on previous work to make sure that the risks associated with the very wealthy are adequately captured, as there are only a small number of random enquiries in this segment.

## 3. Description of population

This estimate is based on the CPR definition of wealthy, that is taxpayers with substantial income or wealth, and complex tax affairs (see annex 1 for more detailed description). This estimate is therefore calculated for a much smaller sample of top end wealthy taxpayers. Extraction of SA data for the 03/04 tax year finds that there were 40980 individuals within CPR's remit with a total declared income of £18.8bn.<sup>2</sup> Thus the average income for a taxpayer within CPR is £458889.

## 4. Type of Estimate

The estimate in this paper is for general non-compliance covering fraud, neglect, error, non-payment and late payments. Avoidance would only be included to a small extent where CPR have recorded yield from avoidance cases. An approximate estimate of avoidance within this estimate is ten per cent or £12-25m (see 5.2). Avoidance cases are often worked by SCI who receive yield for their input and their yield is not included in this estimate. Further work needs to be undertaken to establish an estimate for the total avoidance gap associated with the CPR population.

## 4. Methodology

Each CPR team has an Annual Allocation Summary database which is used to record data on each taxpayer within their area. This includes information about the taxpayers

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<sup>1</sup> KAI paper 04/05 Estimation of tax gap for direct taxes ...

<sup>2</sup> KAI ETR wealth tax gap analysis ...

return, the risk assessment and enquiry process. A copy of the annual allocation summary for each CPR area was obtained to provide data for use in this analysis.

#### **4.1 Calculating the Tax Gap**

##### **Analysis of risk based enquiries for wealthy individuals with a methodology for turning this into a tax gap estimate.**

1. Each taxpayer within a CPR team is risk assessed and given a potential for enquiry score. The potential for enquiry scores are defined as:
  - 1 - Case must be taken up regardless of yield
  - 2 - Definite yield
  - 3 - Yield possible but not certain
  - 4 - Speculative enquiry
  - U - Risk assessment not yet complete
  - X - Reviewed, no enquiry
2. Analysis was undertaken to calculate average yield from settled CPR cases for the 2002/3 tax year. Average yield was calculated for each potential for enquiry score.
3. Each taxpayer is given a potential enquiry score so it was possible to factor up from results of settled cases to the entire CPR population based on risk. (see Annex 2 for detailed explanation about how the grossing was undertaken).<sup>4</sup> Lower, central and upper tax gap estimates were determined by use of multipliers. Multiplier effects<sup>3</sup> are included in tax gap estimates to turn an 'audit gap'<sup>4</sup> based on enquiry data into a tax gap estimate to allow for risks that are not picked up during an enquiry. Multipliers have only been applied to the percentage of the estimate relating to Capital Gains and Other Income because these areas relate to types of non-compliance where if the sources of income are not declared on the return, they are difficult to spot in an enquiry.
  - i) Lower estimate - no multiplier is used.
  - ii) Central estimate - multiplier of 1.64 applied to the element in the estimate due to Capital Gains and Other Income. No multiplier applied to the rest.
  - iii) Upper estimate – multiplier of 3.28 applied to the element in the estimate due to Capital Gains and Other Income.
5. The above methodology was repeated using median values for each risk group.

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<sup>3</sup> Multiplier values taken from KAI paper 04/05 Estimation of tax gap for direct taxes

<sup>4</sup> Audit gap in this paper can be defined as revenue that would be brought in if all CPR cases were enquired into. It will not include risks that remain undetected during an enquiry.

**Table 1: Enquiry Strike rates**

Area	Settled cases	Zero yield cases	Strike rate
A	255	94	63%
B	184	114	38%
C	90	54	40%
D	385	193	50%
E	344	243	29%

Table 1 shows strike rates for areas at the time the enquiry data was extracted. Strike rates for some of the areas were below fifty percent so median yield values were zero in some cases. When the cases were then broken down by risk group across each area, median values were found to be either zero or very low. Calculating the wealthy tax gap using median values was therefore considered to be unreliable.

## **4.2 Problems with the estimate**

- 4.2.1 This tax gap estimate uses settled yield data from enquiries into 2002/3 tax returns. Generally, these cases would have been opened for enquiry between January 2004 which is the deadline for taxpayer returns to be submitted by and January 2005 when the enquiry window closed. The estimate is based on cases that had been settled as at March/April 2006 so the majority of cases in the sample will have settled within two years. There could be an argument that the highest yielding cases are not adequately captured within this estimate because cases that take longer to settle are frequently higher yielding. This problem is likely to be most prevalent in risk group one where a low percentage of cases have been settled compared to the total number that have been opened. However, this argument does not always hold true. For example, litigation cases have a win or lose outcome so could result in zero yield after a lengthy challenge. Repeating the analysis at a later stage when greater proportions of cases have been settled will reduce the magnitude of this caveat.
- 4.2.2 The calculation is based purely on CPR yield. There is an issue that yield arising from an enquiry into a linked entity, for example a Trust, will be claimed by the relevant office and not recorded as CPR yield. Yield for a taxpayer is also recorded outside of CPR when a case is worked jointly by CPR and other business areas such as SCI, employer compliance, Trusts or CT. Yield for the taxpayer is then shared according to the amount of input each area had into the case. The percentage yield can vary widely on a case by case basis so the extent of this issue is not certain but indicates that the tax gap figures will be underestimated. To overcome this, further work could be undertaken to find out how much yield has been obtained from other business areas for the taxpayers within CPR's remit for the 02/03 tax year. This is particularly important in determining how much avoidance there is associated with this population so that a gross tax gap figure can be calculated.

### 4.3 Types of risk

#### **Analysis of CPR enquiries to identify main types of risks for wealthy individuals and breakdown tax gap estimates by risk.**

1. Where an enquiry is opened, a main reason for enquiry code is recorded on the annual allocation summary database for each taxpayer. These codes describe the main risk in the enquiry, for example Capital Gains or Investment Income.
2. Enquiry codes from settled cases were analysed to show the number of cases and yield corresponding to each risk. This indicates which risks are most prevalent in CPR cases.
3. A yield per risk type for each potential for enquiry score has also been calculated.

## 5. Results

### 5.1 Tax Gap Estimates

Table 2 shows the relationship between yield from settled cases for each CPR team and the potential for enquiry score.

**Table 2: Average Yield for Potential Enquiry Scores**

Potential for enquiry code	No. of settled cases	Average yield (£)
1	75	15500
2	207	7500
3	530	6500
4	48	1500
u	14	92500*
x	40	9000
Total	914	

\*Note this includes a £1m case

The pattern corresponds to what would be expected from the potential for enquiry scoring. That is, average yield is highest for risk group one and lowest for risk group four.

Table 3 presents the final estimates for the wealthy tax gap. Using the methodology set out in 4.1, the lower estimate gives the range of the tax at risk for the total CPR population based on the results from settled CPR cases. This could be described as an estimate of the tax that would be brought in if every return were enquired into. The central and upper estimates include multipliers to allow for what is not uncovered by enquiries.

**Table 3: Ranges of for the tax gap estimate**

Tax Gap Estimates* (£)		
Lower estimate	Central estimate	Upper estimate
115-140m	140-170m	210-250m

\*rounded to nearest £5m.

A detailed breakdown of how the tax gap calculation was arrived at is included as Annex 3.

## 5.2 Types of Tax Risk

Where settled cases had a corresponding main reason for enquiry code recorded in the annual allocation summary, the number of cases and subsequent yield associated with each risk could be calculated.

**Table 4: Settled cases with a Main Reason for Enquiry Code (2003)**

Risk Description	No. of cases	Yield (£)	Average Yield (£)
Business	35	376823	10766
Inv Income*	246	2308686	9385
CGT	205	1908743	9311
Sch-E	207	1675006	8092
Trusts	8	61190	7649
Allowances and reliefs	67	419924	6268
Land	58	170731	2944
Total	826	6921104	8379

\*Includes £1m case

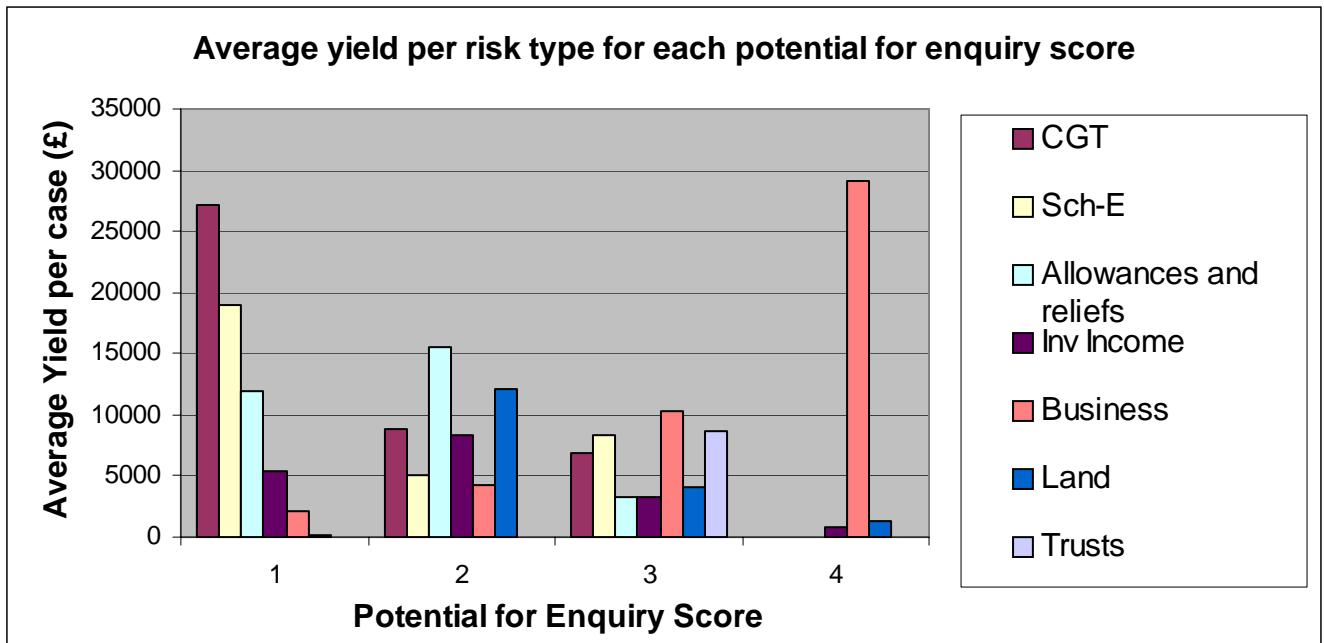
Average yield is highest for settled cases where business risks are the main reason for enquiry but only 35 cases fall into this category. The most frequent reasons for enquiries to be opened are to tackle risks relating to Investment Income, Capital Gains Tax and Schedule E. Each of these categories account for the risks involved in approximately a quarter of settled cases to date. All three of these groups have similar and relatively high average yields per case although investment income includes one very high yielding case which significantly increases the average yield in that group.

In annex four (Table 11), there is a lower level breakdown of these broad categories. An estimate for the percentage of the estimate relating to avoidance has been made based on the Schedule E risks. The sum of the yield from schemes, lump schemes and PAYE avoidance is approximately ten per cent of the yield from settled cases. If it is assumed that avoidance contributes to ten per cent of the overall estimate, then £12-25m of the estimate of the estimate would be attributed to avoidance.

**Table 5: Average yield for each risk type by potential for enquiry score**

Risk Description	Average Yield (£) by Risk Group			
	1	2	3	4
CGT	27172	8900	6824	60
Sch-E	19038	4998	8278	0
Allowances and Reliefs	11864	15617	3276	65
Inv Income	5360	8273	3260	847
Business	2066	4272	10383	29050
Land	172	12049	4116	1293
Trusts	0	0	8741	0

Table 5 shows how average yield for each risk type varies by risk group. Capital Gains can be seen to be a big source of risk in the highest risk group where average yield is £27000 per case. Schedule E and Allowances are also prevalent issues within this group. As a note of caution, when the cases have been broken down to this level of detail some of the sample sizes in each group are quite small. Annex 4, Tables 12 to 15, clearly show the number of cases and total yield associated with each group.



## **6. Conclusions**

- 6.1 Based on information from settled CPR cases for the 2003/4 tax year, the wealthy tax gap for the CPR population is estimated to fall within the range of £115m to £250m. The main tax risks associated with the wealthy relate to Capital Gains, Schedule E and Investment Income.
- 6.2 The estimate given in the paper might be considered to be cautious for two reasons. The first is because there were still open cases into 2003 returns when the data was extracted. Cases that take longer to settle are frequently higher yielding and these cases might not be adequately captured in this analysis. The second is that only CPR yield has been included in this estimate. Where yield is recorded by other areas in the department that have opened enquiries into the taxpayers within CPR's remit or shared yield with CPR, it will not have been included.
- 6.3 This is the first estimate using this methodology and further work could be undertaken to improve reliability. The exercise could be repeated when more 2002/3 cases are settled. The average yields for each potential for enquiry score would then be more reliable. Also, there will be a greater pool of random enquiry results so the reliability of the average yield used as a proxy for x should improve. Further work also needs to be undertaken to understand more about how much tax is collected for the CPR population by SCI and other significant areas involved with this population.

## **Annex 1**

### **Customers within Complex Personal Returns**

CPR teams deal with customers **who have or will shortly have substantial income or wealth, and complex tax affairs.**

**Substantial income or wealth** means:

- Taxable income or gains of £200,000 or more;
- Total assets likely to be worth £5m or more. (Assets include property, stocks and shares, cash, money in trust and any other investments or valuables - basically any form of "wealth".)

**Complex tax affairs** means at least one, and normally more than one, of:

- White space entries on the SA return - other than trivial comments.
- Several different sources of income or gains.
- Press or other media coverage of the customer's finances.
- Income from two or more directorships.
- An entry at box 15.8.
- Claiming partnership losses on a film scheme.
- Some indication of tax planning or involvement in avoidance schemes.
- Entries on the Non-residence pages of the SA return.
- Foreign Income of more than £10,000.
- Income from property and/or trusts of more than £20,000
- Capital gains of more than £10,000 for more than one year.
- Benefits in kind (especially less usual benefits) of more than £10,000

## Annex 2

### Grossing up from settled enquiries to the rest of the CPR population based on risk.

- Tax at risk for potential enquiry scores 1-4 was calculated using two methods.
  - a) Based on average yield from settled cases for each risk group across all areas.
  - b) Area by area, based on average yield from settled cases for each risk group.

The average yields for groups 1-4 calculated using methods a) and b) were then multiplied by the total number of taxpayers falling into each group respectively.

**Table 6: Number of Settled and Open Cases for risk groups 1-4**

Potential for Enquiry Score	Settled	Open	Not Opened*	Percentage of cases where enquiry opened
1	75	1489	229	<b>87</b>
2	207	222	124	<b>78</b>
3	530	934	479	<b>75</b>
4	48	105	394	<b>28</b>
Total	<b>860</b>	<b>2750</b>	<b>1226</b>	

\*No enquiry had been opened on these cases as at March/April 2006 when the allocation summaries were interrogated. The enquiry window for 02/03 returns closed January 2005.

Note that there could be an issue around selection bias when grossing up in this way. This is because the enquiries that are opened within each risk group are not chosen at random, there is further selection within each group and so the average yield might not be considered to be representative. Selection bias has not been corrected for because it is considered that it would only have a minor impact on the estimates in this analysis. Table 6 shows that for risk groups one to three, a high percentage of cases have been opened so the bias would only relate to a small proportion of cases. In category four, where the bias is more pronounced, the average yield figure is low so the overall impact would be small.

- A large percentage of cases, approximately seventy five percent of all taxpayers within CPR, were given an 'x' potential for enquiry score. The definition for 'x' is that the case has been reviewed and there will be no enquiry. However, there are 40 cases with a potential for enquiry score of 'x' where enquiries have been opened and settled. The average yield was £9000 for this group of cases, which is relatively high. It would be possible to gross up to the rest of the 'x' population based on average yield for the 40 cases but it is assumed that these cases do not reflect a typical case falling into the 'x' category. In the notes column of the annual allocation summaries, some of the cases stated 'discovery investigation'. There must have been discovery of further information after the initial review, to change the risk associated with that case and warrant the opening of an enquiry. It would not be accurate to assume that all of the remaining cases within the 'x' category have similar tax at risk. Instead, results of random enquiries within the CPR population have been used as a proxy for cases given a score of 'x'. The

average random enquiry yield was approximately £2000. As a note of caution, this was calculated from a very small sample of random enquiries but nevertheless is considered to be the most sensible figure to use.

- Cases with a potential for enquiry score of 'U' were still being reviewed and so the risk associated with taxpayers in this category was not known. Therefore, cases were redistributed across groups 1-4 and x according to the proportion of total cases falling into each of these groups and then it was assumed that the average yield per risk group would accrue.
- One CPR area uses a different potential for enquiry scoring framework, where scores are given on a range of 1-9. The calculation for this area was dealt with separately but using the same methodology as previously described. This area has a population of 3650 taxpayers and had settled information available for 350 cases.

### Annex 3

#### Tax risks associated with the Very Wealthy

The following tables set out how the tax gap was calculated. The calculation is based on average yield from settled cases for each risk group across all areas.

**Table 7: Tax at Risk for Potential For Enquiry Scores 1-4**

Potential for enquiry code	No. of settled cases	Average yield (£)*	Total pop'n	Tax at risk** (£m)
1	75	15500	2280	35
2	207	7500	1259	10
3	530	6500	2917	18
4	48	1500	1008	1
<b>Total</b>	<b>860</b>		<b>7464</b>	<b>64</b>

\*rounded to nearest £500

\*\*rounded to nearest £1m

The tax at risk for groups one to four has then been calculated by multiplying the average yield for each group by the population of each group. Note that one area is not included in the above table because it has a different risk scoring system so it has been considered separately.

**Table 8: Tax at risk for Category U**

Potential For Enquiry Score	Total population	Percentage of Population	Redistributed u's	Average Yield (£)	Tax at Risk (£)
1	2280	6	95	15500	1450000
2	1259	3	52	7500	400000
3	2917	8	121	6500	750000
4	1008	3	42	1500	50000
u	1556	0	14		
x	29716	80	1232	2000	2450000
<b>Total</b>	<b>38736</b>	<b>100</b>	<b>1556</b>		<b>5150000</b>

The taxpayers falling within category 'u' have been redistributed into the other risk groups according to the total populations in each group. Fourteen cases within the u category have been settled so yield from these cases has been included separately in the tax gap calculation and so these cases have not been redistributed.

**Table 9: Area Z (different potential for enquiry scoring system) tax at risk**

Area Z	Population	Tax at risk (£m)
Risk groups 1-9	459	2
Other settled	161	1
Remaining cases	3034	6
<b>Total</b>	<b>3654</b>	<b>9</b>

**Table 10: Tax Gap Calculation**

	Total Population	Tax at risk (£m)*
Potential for enquiry score (1-4)	7464	65
yield from x/u settled	54	2
Remaining x's	29716	60
Remaining u's	1127	5
Area Z	3654	9
TOTAL	42015	140**

\*Rounded to the nearest £1m\*\*The total is correct but due to rounding does not equal the sum of the components

**Annex 4****Table 11: Detailed breakdown of the number of cases and yield for each risk description across all risk groups**

Code	Description	Notes	Number of cases	Percentage of cases	Yield (£)	Percentage of yield
A01	Allowances and Reliefs	RAR etc	16	2	34778	1
A02	Allowances and Reliefs	All others	49	6	346320	5
A03	Allowances and Reliefs	Other	<#>	0	38826	1
S01	Sch-E	Schemes	24	3	546412	8
S02	Sch-E	Lump Schemes	19	2	137826	2
S03	Sch-E	Pensions	8	1	35703	1
S04	Sch-E	foreign/expats	17	2	511738	7
S05	Sch-E	PAYE avoidance	7	1	17800	0
S06	Sch-E	Living accommodation	<#>	0	9450	0
S07	Sch-E	Dedns/Cap Allces	5	1	13540	0
S08	Sch-E	Benefits - car	22	3	63305	1
S09	Sch-E	Benefits - other	50	6	115226	2
S10	Sch-E	Other	50	6	217389	3
S11	Sch-E	Other	<#>	0	6616.70	0
I01	Inv Income	Interest	199	24	1948267*	28
I02	Inv Income	Dividends	17	2	34992.80	1
I03	Inv Income	Other	30	4	325426	5
B01	Business	Full	<#>	0	0	0
B02	Business	Aspect	31	4	376823	5
L01	Land	Land and property	58	7	170731	2
T01	Trusts	Foreign	<#>	0	12369.00	0
T02	Trusts	All others	6	1	48821	1
CG01	CGT	Land and Property	65	8	750201	11
CG02	CGT	Shares	54	7	450899	7
CG03	CGT	Chattells	0	0	0	0
CG04	CGT	Business Assets	5	1	49705	1
CG05	CGT	Foreign Remittances	<#>	0	0	0
CG06	CGT	Taper Relief	19	2	178677	3
CG07	CGT	Losses	29	4	276936	4
CG08	CGT	Dedns/expenses	5	1	14034	0
CG09	CGT	Other	25	3	158627	2
CG10	CGT	Other	<#>	0	29664	0
CG15	CGT		<#>	0	0	0
			826	100	6921104	100

<#> In line with HMRC's duty of confidentiality (as set out in section 18 of the Commissioners for Revenue & Customs Act 2005) and the Office for National Statistics 'Protocol on Data Access and Confidentiality', we have not disclosed the number of cases where this is fewer than five.

## Breakdown of types of risk by potential for enquiry score

**Table 12: Potential for enquiry score ‘1’**

Risk Description	No. of cases	Yield (£)	Average Yield (£)
CGT	23	624950	27172
Sch-E	13	247491	19038
Allowances and reliefs	8	94915	11864
Inv Income	15	80397.6	5360
Business	<#>	6199	2066
Land	5	860	172
Trusts	0	0	0
Total	67	1054812	15744

**Table 13: Potential for enquiry score ‘2’**

Risk Description	No. of cases	Yield	Average yield (£)
Allowances and reliefs	21	327961	15617
Land	5	60246	12049
CGT	30	266989	8900
Inv Income	69	570841	8273
Sch-E	51	254888	4998
Business	12	51265	4272
Trusts	<#>	0	0
	189	1532190	8107

**Table 14: Potential for enquiry score ‘3’**

Risk Description	No. of cases	Yield	Average Yield (£)
Business	18	186898	10383
Trusts	7	61190	8741
Sch-E	122	1009926	8278
CGT	136	928095	6824
Land	37	152308	4116
Allowances and reliefs	30	98279	3276
Inv Income	136	443342	3260
Total	486	2880038	5926

<#> In line with HMRC's duty of confidentiality (as set out in section 18 of the Commissioners for Revenue & Customs Act 2005) and the Office for National Statistics 'Protocol on Data Access and Confidentiality', we have not disclosed the number of cases where this is fewer than five.

**Table 15: Potential for enquiry score ‘4’**

<b>Risk Description</b>	<b>No. of cases</b>	<b>Yield</b>	<b>Average Yield (£)</b>
Business	<#>	29050	29050
Land	6	7757	1293
Inv Income	14	11859	847
Allowances and reliefs	<#>	261	65
CGT	10	595	60
Sch-E	<#>	432	0
Trusts	0	0	0
Total	35	49954	1427

<#> In line with HMRC's duty of confidentiality (as set out in section 18 of the Commissioners for Revenue & Customs Act 2005) and the Office for National Statistics 'Protocol on Data Access and Confidentiality', we have not disclosed the number of cases where this is fewer than five.