



Protecting Tax Revenues 2009

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1 Executive summary

1.1 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 contribute their fair share towards funding public services. However, the minority who do not put pressure on the public finances and impose costs, including higher taxes, on others. This undermines fairness and confidence in the tax system.

1.2 The Government is committed to ensuring the tax system operates fairly and effectively, and has set HM Revenue and Customs (HMRC) an ambitious target to reduce losses by £7 billion over the period 2007-08 to 2010-11. To deliver this, HMRC has developed a comprehensive risk based compliance strategy in accordance with international best practice. Analysis of the tax gap is required to understand where the risks to revenues fall across the tax system and the behaviours driving them. This allows HMRC to use its resources most effectively in protecting tax revenues. There have been notable successes, such as significant reductions in fraud and rapid responses to artificial avoidance schemes. The yield from compliance interventions has increased from £7.5 billion in 2005-06 to £12 billion in 2008-09.

1.3 HMRC has published estimates of the indirect tax gap since 2001. Further improvements to methodologies mean that the Department is now in a position to publish an estimate of the size and behaviours underpinning the overall tax gap. The size of the UK tax gap is estimated to be around £40 billion in 2007-08. This is a net figure after accounting for HMRC's compliance activities, which reduced the tax gap by over 20 per cent. The net tax gap represents around 8 per cent of the total tax, which in HMRC's view should be collected, and compares favourably to estimates produced by other countries. The tax gap is driven by a wide range of behaviours, from simple error and failure to take reasonable care to evasion and criminal attacks.

1.4 The Government's goal is to reduce the tax gap as far as possible without placing disproportionate burdens on the majority of businesses and individuals who already pay their fair share. HMRC is delivering this by:

- **supporting customers by helping them to get it right first time through education and reducing compliance costs.** For example, through the delivery of online services designed to help reduce error;
- **preventing revenue loss by minimising opportunities for avoidance and deterring non-compliance.** For example, the introduction of the disclosure regime has helped close down over £12 billion in avoidance opportunities; and
- **tackling non-compliance through effective identification practices, and the appropriate use of civil and criminal sanctions.** For example, information obtained from the high street banks underpinned the first Offshore Disclosure Facility (ODF), which brought in £450 million in tax from undeclared offshore assets.

1.5 The 2009 Pre Budget Report builds on this by announcing further measures to address the behaviours underpinning the tax gap. These include new proposals to strengthen the tax avoidance disclosure regime and the introduction of a new notification requirement for holders of offshore bank accounts, supported by a new penalty regime.

2 Introduction

A fair and effective tax system

2.1 A fair and effective tax system is required for the Government to be able to deliver its wider objectives. Those who attempt to pay less than their fair share undermine the funding of public services and threaten medium term fiscal consolidation. Therefore the Government is committed to supporting those who seek to pay their fair share and to deterring and challenging those who do not.

Protecting tax revenues

2.2 Most customers comply with their tax obligations as far as they are able. HM Revenue and Customs (HMRC) receives a high level of co-operation from businesses, professional advisers and individual customers to help the tax system run smoothly. This cooperation enables HMRC to collect the majority of receipts, £451 billion in 2007-08, through the principles of self assessment and withholding tax at source, for example Pay As You Earn (PAYE). The Government recognises the importance of this and is committed to making it easier for customers to meet their obligations and helping those experiencing financial difficulties.

2.3 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 customers who do not fully understand tax rules. Some use highly artificial avoidance schemes to reduce tax payments. A minority deliberately set out to evade their obligations or to profit through criminal attacks on the tax system.

2.4 Such behaviours pose a significant threat to the integrity of the tax system and to the delivery of public services. Non-compliance contributes to a shortfall in revenue, requiring tax rates to be higher than they would otherwise need to be. It also contributes to erosion of the principle of fairness in the tax system and to increased compliance costs resulting from the need for broad measures to protect revenues.

The Government's approach

2.5 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 against those that do not; 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, incidence and drivers of non-compliance;

- **comprehensive**, including legislative changes to improve the structure and resilience of the tax system alongside new operational approaches to make the system less vulnerable, while minimising burdens on customers; and
- **performance-based**, with HMRC being set targets for reducing underpayments as a central part of their performance framework.

2.6 This approach is in line with the best practice recommended by the Organisation for Economic Cooperation and Development (OECD) for identifying and prioritising tax risks and developing strategies to counter them.¹

2.7 HMRC operates a risk based compliance strategy, focusing resources on the areas of highest risk to most effectively secure tax revenues. Analysis of the tax gap provides a comprehensive and thorough understanding of the risks to the tax base and the behaviours driving them, informing HMRC's approach to protecting tax revenues.

2.8 This document sets out:

- how HMRC has developed the evidence base over time, and compares the UK tax gap with the available estimates for other countries in Chapter 3;
- how HMRC's performance in reducing the tax gap is measured in Chapter 4; and
- how HMRC uses tax gap analysis to inform its approach to compliance and provides a detailed account of the specific actions HMRC are taking to reduce the size of the tax gap in Chapter 5.

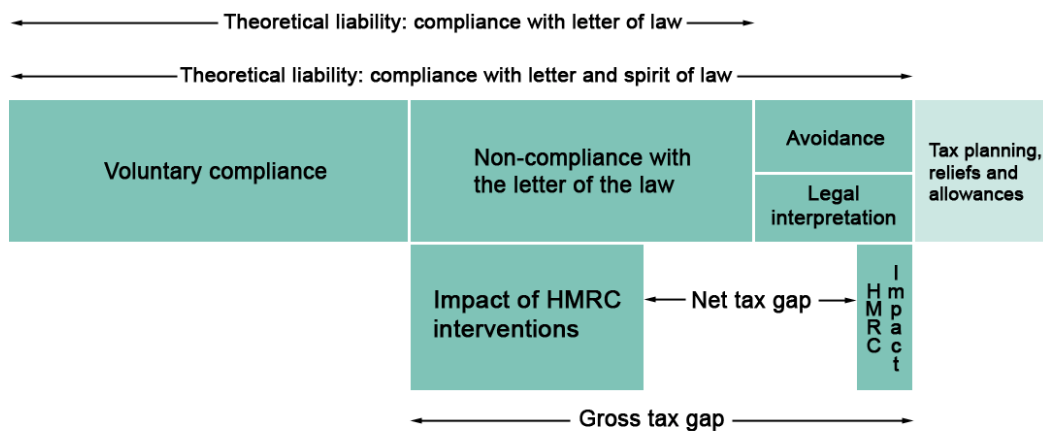
¹ *Compliance Risk Management: Managing and Improving Tax Compliance*, OECD Committee on Fiscal Affairs (2004). This can be downloaded from <http://www.oecd.org/dataoecd/21/55/37212610.pdf>

3 Developing the evidence base

3.1 Estimating the shortfall in revenue between the tax collected and the tax that which should be collected (the theoretical liability) commonly referred to as the tax gap, is inherently difficult and complex. This is because many of the activities that contribute towards the tax gap are deliberately concealed from HM Revenue and Customs (HMRC). Consequently many of the resulting estimates are necessarily subject to large margins of error.

3.2 The theoretical tax liability represents the tax that would be paid if all individuals and companies complied with both the letter of the law and HMRC’s interpretation of the intention of Parliament in setting law (referred to as the spirit of the law). This includes unpaid tax, and tax not collected when HMRC’s interpretation of the law is successfully challenged. The UK tax gap figure is net of the Department’s compliance activities. The estimate therefore takes into account the additional tax recovered through compliance and enforcement activities, which brought in over £11 billion in 2007-08. Figure 3.1 illustrates the UK definition of the tax gap.

Figure 3.1: UK definition of the tax gap



3.3 HMRC first published an estimate of the tax gap for the main indirect taxes in 2001. These methodologies are reviewed each year and have been substantially improved and new estimates have been developed, such as for hand rolled tobacco. Analysis of the scale of tax gaps for direct taxes is more difficult as there are no independent sources of data describing the taxable income for the various taxpayer populations. However, methodologies using information acquired from compliance activities have been developed, tested and refined. HMRC first published direct tax estimates for losses and non-payment from inaccurate self-assessment returns in 2008. As a result of further work, the Department is now in a position to be able to publish estimates for avoidance, large businesses and individuals who do not receive a self-assessment return.

3.4 *Measuring Tax Gaps 2009*, published today, sets out estimates of tax gaps for direct and indirect taxes.² The overall tax gap is produced by combining estimates where robust methodologies exist, such as VAT, with estimates arising from newly developed methodologies, such as corporation tax for the largest businesses, and illustrative estimates for components where methodology is not yet developed, for example large partnerships. The estimate of the overall size of the UK net tax gap in 2007-08 is around £40 billion.

3.5 The UK tax gap estimate represents around 8 per cent of the theoretical tax liability. This compares favourably to the estimates available from other tax authorities and shows that most UK taxpayers fulfil their obligations and pay their fair share of tax.

3.6 The 2007-08 estimates predate much of the impact of the economic downturn. Tax gap figures for 2008-09 are available for VAT – see *Measuring Tax Gaps 2009*. Because of the way in which the VAT gap is measured it is affected by sharp increases in new debt even though much of that debt is likely to be short term. This is one of the main drivers behind the increase in the 2008-09 VAT gap. HMRC has taken a series of actions to tackle debt and to help businesses in financial difficulties, as set out in Chapter 5.

International comparisons

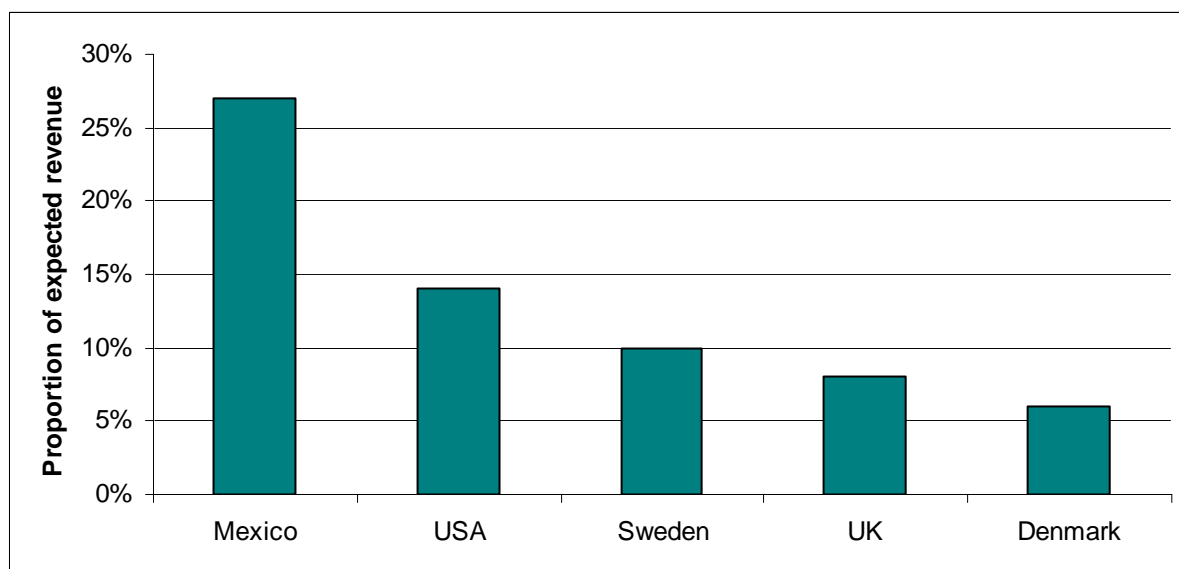
3.7 Every country has a tax gap. However, only a small number of countries publish tax gap estimates and a large amount of caution needs to be exercised in making any comparisons between these estimates. There is no single definition of what constitutes the tax gap or any common methodology for measuring it. There are also significant differences in the tax systems and taxpayer populations, as well as the amount and level of detail available for analysis.

3.8 HMRC's definition of the tax gap is wider than the definitions used by other tax authorities. Several countries prefer to use estimates based on unpaid tax; for example, US tax gap estimates do not include losses resulting from challenges to the law such as avoidance. The Department recognises that to protect tax revenues it must tackle all threats to the tax base, including behaviours that challenge the interpretation of the law, such as avoidance. The tax gap estimates therefore provide a comprehensive picture of threats to the tax base by including amounts due according to HMRC's interpretation of the intention of Parliament in setting law.

3.9 Figure 3.2 sets out a comparison of tax gap estimates that are available from other countries. It demonstrates that non-compliance with the tax system is an issue facing all countries and that the UK's estimate is at the lower end of the range even when using a relatively wide definition of the tax gap.

² Downloadable from http://www.hmrc.gov.uk/stats/tax_gap/menu.htm

Figure 3.2: International tax gap estimates ³



3.10 Tax gap analysis provides insight into the distribution and underlying behaviours behind non-compliance that enable HMRC to continue to develop responses. This is discussed in Chapter 5. The following chapter outlines how HMRC is measuring its performance in reducing tax losses.

³ Mexico: 2004, IT, VAT and 'special taxes on production and services'. Derived from data available in http://www.sat.gob.mx/sitio_internet/informe_tributario/informe2008t1/reporte2007.pdf
USA: 2001, IT and CT. http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf
Sweden: 2001 – 2005, IT, VAT, Tax on capital, social security charges, excise duty, other taxes. <http://www.skatteverket.se/download/18.3a7aab801183dd6bfd3800014376/234b01.pdf>
UK: 2007 – 08, IT, CT, Stamps, CGT, NICs, VAT, Excise duties.
Denmark: 2007, IT, CT, VAT and 'other'. [http://www.rigsrevisionen.dk/media\(828,1033\)/03-2008.pdf](http://www.rigsrevisionen.dk/media(828,1033)/03-2008.pdf)

4 Measuring performance

4.1 As set out in Chapter 2, the Government's approach to protecting tax revenues includes performance based measurement. The Government recognises that without imposing disproportionate burdens on all taxpayers it would not be possible to completely eliminate all the behaviours behind the tax gap. The OECD's Forum on Tax Administration has stated that:

“tax administrations will never be able to collect every dollar of tax due. In fact, it can be argued that this should not be the goal since the measures required to do this would be so intrusive as to lead taxpayers to revolt”.⁴

4.2 The Government's goal is to reduce the tax gap as far as possible without placing disproportionate burdens on businesses and individuals. To achieve this, the Government has set HM Revenue and Customs (HMRC) a target to reduce losses by £7 billion over the period 2007-08 to 2010-11. This is one of the Department's key Departmental Strategic Objectives (DSOs) (see Box 4.1).

Box 4.1: HMRC's Departmental Strategic Objective 1 (2007-08 to 2010-11)

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

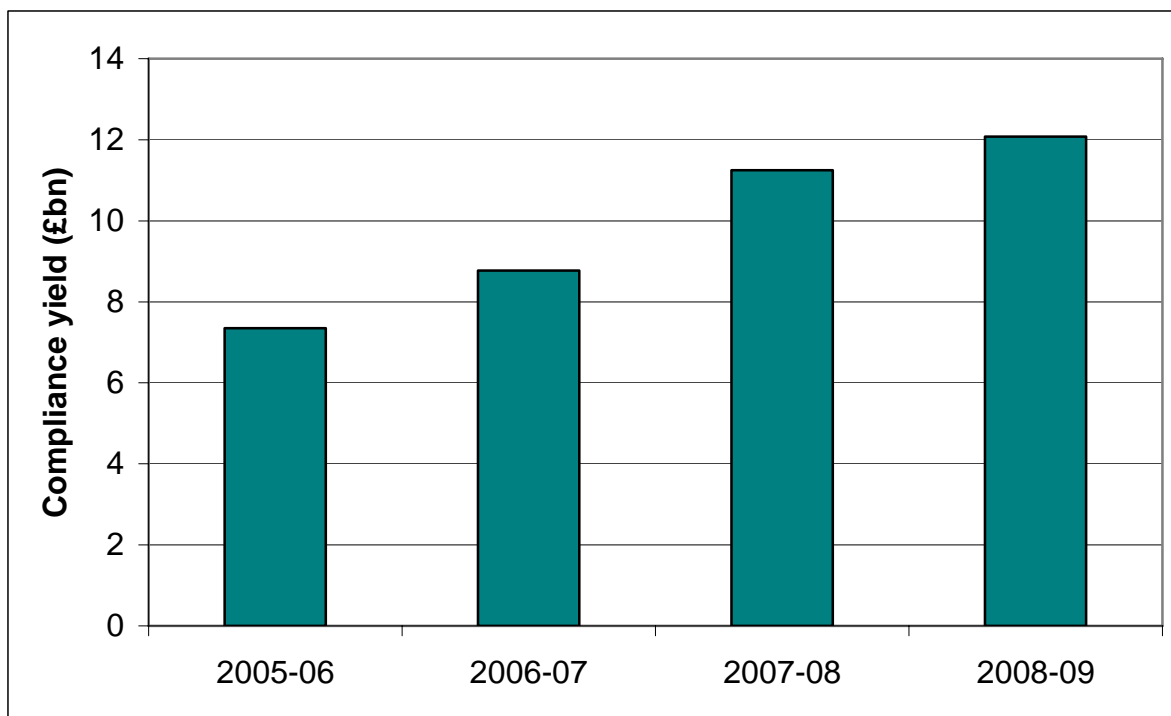
Key outcomes are:

- 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.

4.3 DSOs are high level, outcome based targets designed to measure achievements towards certain objectives over a Spending Review period. Because of the function DSOs serve and the fact that the final results are often not available until after the Spending Review period it is useful to have complementary indicators to track performance in the shorter term. Compliance yield provides a measure of the additional tax received resulting from HMRC's compliance activity. Figure 4.1 sets out the amounts of compliance yield that have been bought in over time and shows that in 2007-08 the tax gap would have been over £11 billion more without HMRC's compliance interventions. This is equivalent to reducing the gross tax gap by over 20 per cent.

⁴ OFFSHORE TAX EVASION, The role of Exchange of Information, by Jeffrey Owens, Director, Centre for Tax Policy and Administration OECD, 2007 <http://www.ceff.univ-cezanne.fr/documents/owen.doc>

Figure 4.1: HMRC Compliance yield since 2005-06



4.4 The following chapter outlines the actions that are being taken to protect tax revenues as a result of the understanding of the behaviours driving non-compliance provided by the tax gap estimates.

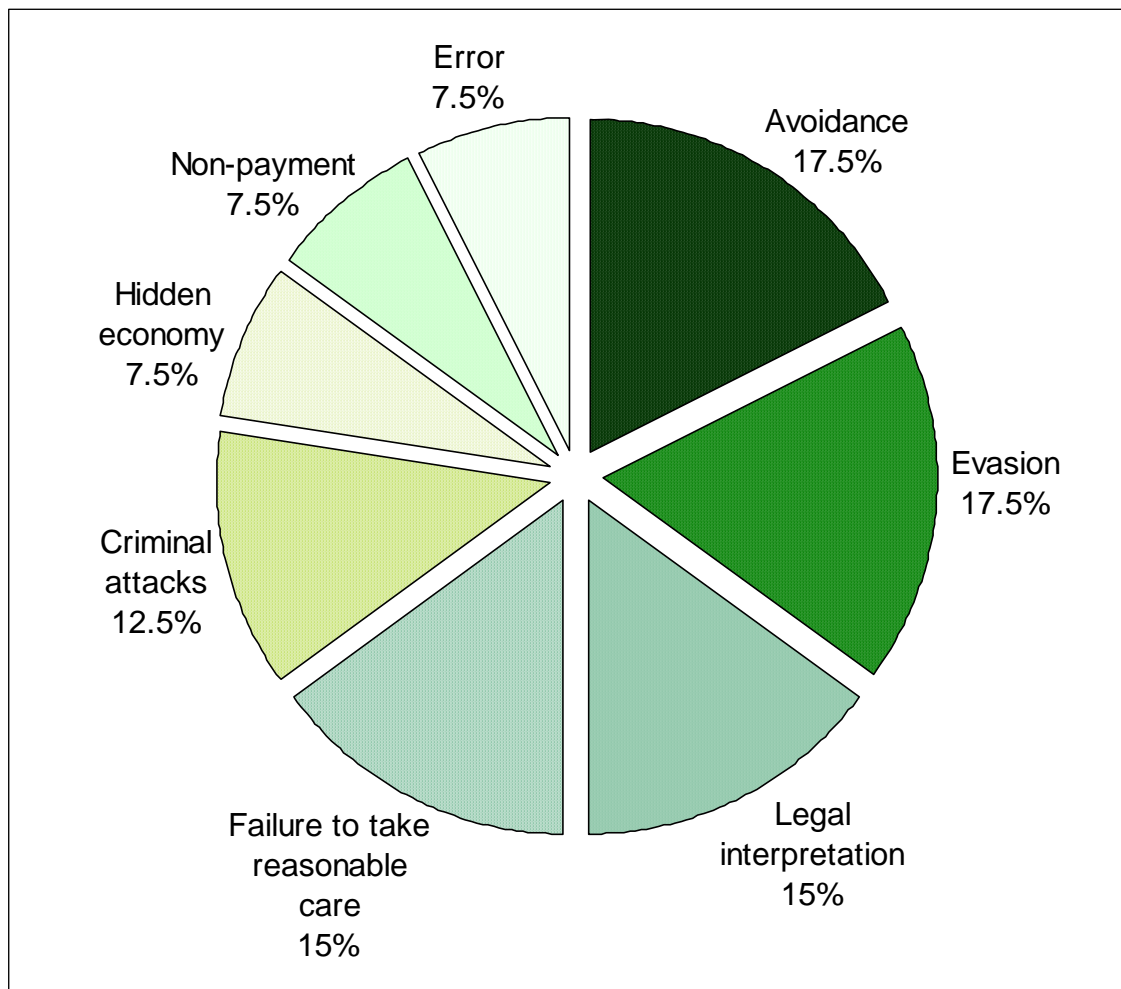
5 Tackling the tax gap

5.1 This chapter provides more detail on HM Revenue and Custom's (HMRC) approach in using analysis of the tax gap to tackle the drivers of the tax gap effectively. It also describes the range of measures that HMRC are taking to reduce the tax gap.

Breaking down the tax gap by behaviour

5.2 Analysis of the underlying behaviours that drive the tax gap is useful as by identifying these behaviours HMRC can most effectively develop a targeted approach, prioritising operational resources and identifying where policy solutions are required.

Figure 5.1: The behaviours driving the net UK tax gap in 2007-08⁵



⁵ HMRC are not able to produce robust statistical elements of the split of the tax gap by behaviour. The analysis in figure 5.1 is based on management assumptions and judgement, and therefore should not be regarded as Official Statistics. As better information becomes available these proportions may alter, although experience indicates that this picture is broadly correct.

5.3 These behaviours, as set out in Figure 5.1, range from errors or lack of care by customers who do not fully understand the tax rules, to a small minority who deliberately set out to evade their obligations. 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 shortfall in revenue and higher costs for other taxpayers.

5.4 The descriptions of what these behaviours are, and what HMRC is doing to address them, are set out below. This builds on the work outlined in *Protecting Tax Revenues*, published in March 2008.⁶

Actions to reduce the tax gap by behaviour

5.5 HMRC is working to reduce losses further through a customer-focused strategy based on support, prevention and tackling those who try to obtain an unfair advantage.

Tackling avoidance

5.6 Avoidance involves the use of schemes or arrangements that seem to HMRC to have been implemented primarily in order to deliver a tax advantage. It is estimated to contribute to around 17.5 per cent of the net tax gap.

5.7 There will always be a minority of tax agents and their clients who seek to minimise their taxes by bending the rules to breaking point. HMRC's Anti-Avoidance Strategy is designed to prevent avoidance and counter it effectively where it is attempted. HMRC aims to persuade customers not to attempt to engage in avoidance by:

- making tax law robust against avoidance;
- engaging with customers about our approach to avoidance;
- optimising our operational response to avoidance; and
- changing the economics of avoidance to make it less attractive.

5.8 HMRC is using this strategy to address avoidance in a number of ways:

- using the disclosure regime to detect and counter avoidance (see Box 5.1);
- minimising the opportunities for avoidance, for example by introducing principles based legislation and scrutinising new tax law to minimise opportunities for avoidance;
- providing information, through the "Spotlights" internet page, on avoidance schemes that HMRC are aware of, but which are viewed as not working, in order to deter take-up; and

⁶ *Protecting Tax Revenues* www.hmrc.gov.uk/budget2008/protecting-tax-revenues.pdf

- working closely with other jurisdictions through the Joint International Tax Shelter Information Centre (JITSIC) and other international groups to combat avoidance and global tax risks.

5.9 The 2009 Pre Budget Report (PBR) improves HMRC's ability to detect avoidance threats and addresses a number of legislative weaknesses by:

- consulting on a package of measures to strengthen and enhance the disclosure regime (see Box 5.1);
- introducing a Code of Practice for the banking sector to encourage responsible tax planning, governance and transparency; and
- announcing a number of targeted measures to close down artificial avoidance schemes.

Box 5.1: Disclosure of Tax Avoidance Schemes

In 2004, the Government introduced Disclosure of Tax Avoidance Schemes (DOTAS) legislation. This at first covered only direct tax schemes concerning employment or certain financial products, but has since been extended to cover most areas of direct tax and National Insurance Contributions. There is a separate disclosure regime for VAT avoidance.

Under DOTAS, anyone promoting a tax avoidance scheme must disclose the scheme to HMRC within five days of making it available. As well as acting as a deterrent, DOTAS enables HMRC to detect emerging avoidance threats and identify users of avoidance schemes. Early information through DOTAS and other intelligence allows early action to close down schemes where necessary, as well as helping inform where to direct operational activity. It has proved to be highly successful and the Government has used information from DOTAS to introduce a range of anti-avoidance measures every year since 2004, closing off over £12 billion in avoidance opportunities. In 2009 Ministers were able to act within 5 days of receiving intelligence to announce legislation, with immediate effect, to close down schemes that sought to generate artificial employment losses.

The 2009 PBR builds on this by announcing a consultation on the implementation of measures intended to strengthen and enhance the DOTAS regime, and ensure it keeps pace with the market for tax avoidance schemes. The measures include enhanced penalties for failure to disclose a scheme, a requirement for promoters to provide lists of clients to whom they have issued scheme reference numbers, and amendments and additions to the "hallmarks" (descriptions of schemes required to be disclosed).

Bearing down on evasion

5.10 Tax evasion is illegal, and arises where individual or corporate customers deliberately omit, conceal or misrepresent information in order to reduce their tax liabilities. Behavioural research has shown that a minority are willing to break the law to avoid paying their fair share of tax.⁷ This could be an individual concealing sources of income or a company suppressing its turnover. Evasion accounts for around 17.5 per cent of the net tax gap.

5.11 HMRC bears down on evaders by tackling existing evasion and by preventing evasion from occurring in the first place. This is achieved by:

- improving targeting of evaders through better risk profiling;
- deterring potential evaders by altering the risk to reward ratio by ensuring that those evading tax are subject to appropriate civil and criminal interventions; and
- changing public attitudes to instigate longer term behavioural change.

5.12 Examples of how this approach is changing the landscape for evaders include:

- investment in data matching tools and the use of third party information to identify evaders;
- using new powers to tackle evasion, enabling us to check in-year records, make unannounced visits in the most serious cases and impose behaviour-based penalties that require higher penalties for evasion;
- the ground-breaking agreement reached with Liechtenstein on future cooperation and information sharing and tackling past evasion, including the back payment of tax, together with interest and a set penalty; and
- the UK Presidency of the G20, which has led to a step change in improving tax transparency, including establishing a clear international standard for tax transparency; setting up a robust peer review process to ensure that countries deliver on their commitments and agreeing a toolbox of sanctions that can be applied to countries that do not implement the standard.

⁷ The research report *Individuals prioritisation: an investigation into segmentation of the Individuals customer base* can be downloaded from <http://www.hmrc.gov.uk/research/individuals-prioritisation-publication.pdf>

Box 5.2: Tackling offshore tax evasion

In 2007 HMRC conducted the first Offshore Disclosure Facility, underpinned by information from five major UK banks. It has delivered around £450 million from disclosures and follow-up compliance activity to date.

Following a recent tribunal decision, HMRC is receiving details on offshore bank accounts from over 300 other financial institutions. The New Disclosure Opportunity (NDO), based on this new information, is currently open. HMRC is giving those with undeclared offshore assets a final chance to come forward and put their affairs in order. This notification window runs until 4 January 2010. At the end of this period, HMRC will review the data held to identify tax evaders who have not come forward.

The 2009 PBR builds on this by announcing new powers and penalties to tackle offshore evasion. The Government will introduce legislation to ensure that those who fail to declare offshore tax liabilities will face the tough penalties attracted by deliberate tax evasion. There will also be a new notification requirement for offshore accounts in certain jurisdictions, supported by a separate penalty regime. Evading tax offshore could therefore result in combined penalties of up to 200 per cent of the unpaid tax.

5.13 The Government has given HMRC new powers to reduce tax evasion, including;

- publishing the names of deliberate tax defaulters, where individuals or companies have deliberately understated significant amounts of tax. HMRC expects this to apply to tax periods starting after 1 April 2010;
- requiring those who have deliberately evaded tax liabilities over £5,000 to provide more detailed information in subsequent years; and
- tackling offshore evasion with the new powers and penalties announced in the 2009 PBR (see Box 5.2).

Resolving issues of legal interpretation

5.14 Legal interpretation relates to the potential tax loss from cases where HMRC and customers have different views of how, or whether, the law applies to specific and often complex transactions. Examples include the correct categorisation of an asset for allowances, the allocation of profits within a group of companies, or VAT liability of a particular item. In these situations the customer will have an alternative view of the law and of how it applies to the facts in their case to that held by HMRC. Around 15 per cent of the net tax gap is estimated to result from these issues.

5.15 HMRC's approach to issues of legal interpretation is strategic and risk based. This has been developed to deal with the tax affairs of large businesses based on:

- providing greater certainty on how transactions will be treated;
- taking an efficient, risk-based approach;

- using effective consultation and dialogue to resolve issues quickly and achieve clarity.

Box 5.3: Review of Links with Large Business

Implementation of the recommendations from the 2006 Review of Links with Large Business has resulted in HMRC developing its approach to managing its relationship with the largest business customers, and developing effective relationships with a further 10,400 of the largest businesses.

The development of the Customer Relationship Manager role has encouraged more open and transparent relationships. Greater engagement has increased HMRC's understanding and knowledge of how large business operates and the commercial factors that influence the decisions made. The improved dialogue and sharing of integrated risk assessments has led to better risk identification, increased working in real time and speedier resolution of issues. By quickly resolving the number of small risks on hand the Large Business Service (LBS) has been able to focus resources on the most significant risks.

5.16 Specific HMRC actions include;

- improving the Non-Statutory Business Clearance service, to the extent that 96 per cent of large businesses say that it addresses their needs fully or mostly;
- Implementing the recommendations from the 2006 Review of Links with Large Business (see Box 5.3); and
- using dedicated project teams to resolve complex issues in the High Risk Corporates Programme, which focuses on a small number of the highest risk businesses. So far this year additional yield of £1.36bn has been recorded across all of the largest business cases.

5.17 HMRC is continuing to better resolve issues of legal interpretation, by:

- extending this risk-based approach to large companies not dealt with in LBS; this will ensure that more risks of this nature are identified and addressed;
- increasingly using a principles based approach to drafting legislation to make the purpose and application of the law clearer; and
- using the Litigation and Settlement Strategy to improve the operational response to technical challenges by encouraging HMRC to drop marginal or lower value cases and use resources to focus on the most significant areas of risk.

Reducing failure to take reasonable care

5.18 Failure to take reasonable care can lead to tax loss when customers are careless or negligent in dealing with their tax affairs. This can range from an individual failing to keep a record of bank interest received in order to complete their tax return to a large company not having adequate systems in place to record expenditure in the appropriate tax categories. This type of behaviour accounts for 15 per cent of the net tax gap.

5.19 It is important that customers take the care expected over their tax affairs. HMRC has a number of approaches designed to ensure customers can live up to their responsibilities by:

- making it easier for customers to get things right first time;
- working with customers and agents to ensure they understand their obligations;
- increasing the number of checks to identify failure to take reasonable care; and
- penalising those who fail to meet their obligations, where appropriate.

Box 5.4: Helping Business to Get it Right

Businesses go through many different stages and processes related to tax during the course of their life. In order to help businesses get their tax affairs right and also reduce failure to take reasonable care, HMRC has developed and introduced education and guidance for businesses that will help guide them through key events, including:

- pre-registration and registration requirements;
- keeping records, filing and being aware of legislative changes;
- paying (and debt management);
- using an agent or intermediary;
- compliance correction and aftercare; and
- stopping trading.

HMRC has been working closely with partners in local government, high street banks and further education colleges to ensure that customers are aware of their responsibilities through a support model for new business based on web, telephone and workshops delivered by HMRC and its partners.

5.20 In recent years, HMRC has taken a range of complementary measures including:

- new requirements for Senior Accounting Officers of the largest companies to ensure that companies have systems and processes that enable them to calculate their tax liabilities correctly;
- sanctions, such as penalties, on those who persistently fail to take reasonable care. These include the potential for suspended penalties which will become payable if conditions set at the time of suspension are not met. This will provide new incentives for people to take more care with their tax affairs; and
- national campaigns and local projects to support specific customer groups. These use a combination of advertising, collaboration with trade and professional bodies, and large scale mail and telephone contact to ensure customers understand their obligations.

5.21 The Government is committed to continuing to simplify and improve the tax system where it can, and make it easier for customers to understand what is expected from them. Since 2006, HMRC has implemented or committed to new measures that will deliver administrative savings to individual businesses of around £540 million per annum.

5.22 HMRC continue to support customers by simplifying and improving processes and guidance across all taxes, working with employers, advisors and other intermediaries to help them get things right, by:

- piloting five toolkits with around 200 agents to prepare the 2009-10 Income tax and Corporation tax returns; and
- developing new compliance checking processes, including visits to customers to inspect current records and gain assurance that these are sufficient to meet statutory record keeping requirements.

Combating criminal attacks

5.23 Organised criminal gangs undertake co-ordinated and systematic attacks on the tax system. Examples include Missing Trader Intra-Community (MTIC) fraud and the use of false identities to obtain tax payments. HMRC's estimates indicate that criminal attacks account for about 12.5 per cent of the net tax gap.

5.24 Criminal attacks are becoming increasingly sophisticated as those involved constantly adapt their tactics in response to HMRC's actions. Although it is not possible to completely eliminate criminal attacks on the tax system without imposing disproportionate requirements on all customers, the Government has responded vigorously with a range of measures to:

- deter criminal attacks on the tax system;
- disrupt and dismantle their activities and prosecute those responsible; and

- attack the economics of fraud to make it less attractive.

5.25 To date HMRC has achieved real success in this area by targeting the people, goods and money flows associated with fraud:

- as a result of a comprehensive MTIC strategy, attempted fraud is estimated to have fallen from £4.5 - £5.5 billion in 2005-06 to £1 - £2.5 billion in 2007-08, a reduction of £3 billion over the period;
- in 2008-09 alone HMRC secured 54 convictions of those involved in MTIC fraud, with sentences totalling 230 years and 21 confiscation orders worth approximately £40 million; and
- the illicit market shares for the main excises have fallen substantially since 2000, with spirits, cigarettes and GB diesel falling by more than 50 per cent.

Box 5.5: Missing Trader Intra-Community (MTIC) Fraud using Carbon Credits

In its simplest form, MTIC fraud involves obtaining a VAT registration to acquire goods or services 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.

Earlier this year HMRC intelligence and operational activity identified a real and increasing risk of the UK becoming a major target for a form of this fraud in connection with trading of emissions allowances (often called 'carbon credits'). The Government therefore introduced legislation to zero rate the supply of emissions allowances within the UK with effect from 31 July 2009. The Government took this early action to prevent substantial potential losses to the Exchequer and to ensure that fraudulent trading did not undermine the legitimate market.

5.26 As attacks continually mutate and new threats are identified, HMRC is continuing to respond robustly by, for example:

- updating its tobacco and alcohol fraud strategies in partnership with the United Kingdom Border Agency (UKBA), to strengthen protection at the border;
- identifying and tackling new MTIC threats before they take hold (see Box 5.5);
- making processes and systems more secure against fraud, by introducing the Identity Authentication Service (IDAS); and
- working more closely with partners both across the UK and internationally.

Tackling the hidden economy

5.27 The hidden economy consists of any undeclared economic activity arising from sources entirely unseen by HMRC. This definition distinguishes the hidden economy from evasion, which is the understatement of liability arising from sources known to the Department. Individuals in the hidden economy behave in a range of different ways, from employee moonlighters who do not think that additional cash work is taxable to ghosts who deliberately conceal their taxable activities in full. HMRC estimates that the hidden economy contributes to 7.5 per cent of the net tax gap.

5.28 HMRC has developed a comprehensive range of responses to target the hidden economy. These are designed to:

- enhance HMRC's capacity to detect those in the hidden economy through improved risk profiling;
- make it easier for individuals to rejoin the formal economy; and
- change public attitudes to deliver longer term behavioural change.

Box 5.6: Hidden Economy Advisory Group

The PBR in 1999 commissioned a report into the hidden economy by Lord Grabiner QC, which reported at Budget 2000. Lord Grabiner's Report made a number of wide-ranging recommendations, covering detection, punishment, prevention and incentives for joining the formal economy. The Government welcomed these findings, implementing them across a number of departments.

In the intervening 10 years, significant factors have affected the hidden economy. These include institutional changes, such as the formation of HMRC, and socio-economic shifts such as the increase in migration from EU accession states. For this reason, there is again an opportunity to utilise external expertise in considering these issues.

The 2009 PBR therefore announces the formation of a Hidden Economy Advisory Group including independent experts in tax and social economics. The Group will examine the tax system and HMRC's administrative processes and consider whether they facilitate or prevent people from joining the formal economy. Its initial findings will include advice on practical and immediate steps that could be taken by HMRC to increase the number of people that make the transition from the hidden to the formal economy.

5.29 Examples of HMRC's responses to address the hidden economy include (in addition to the actions to bear down on evasion):

- introduction of a fraud hotline enabling the public to report those they suspect of working in the hidden economy by phone or online;

- working more closely with other government departments and enforcement agencies (such as the Department for Work and Pensions and UKBA) to identify and tackle ghosts and moonlighters;
- introducing ‘failure to notify’ penalties designed to influence behaviour by providing an incentive for people to join the formal economy both earlier and unprompted, in return for lower penalties or no penalty.

5.30 In addition to the Hidden Economy Advisory Group set out in Box 5.6, HMRC is taking action to exploit the high natural turnover in the population of the hidden economy by devising mechanisms and responses that will restrict the number of those able to join the hidden economy population and remain unseen. In this way HMRC are aiming to shrink the size of the hidden economy.

Reducing the levels of debt

5.31 ‘Non payment’ refers to tax debts that are written off by HMRC and therefore result in a permanent loss of tax – mainly as a result of businesses becoming insolvent. It does not, therefore, include debts that are eventually paid. Non-payment makes up around 7.5 per cent of the net tax gap.

5.32 There will always be those who are unable, and a minority who are unwilling, to pay their established tax liabilities. During a time of economic downturn more individuals and businesses find it difficult to pay what they owe to HMRC in full and on time.

5.33 HMRC are working to reduce the level of preventable debts. HMRC’s debt strategy seeks to do this by:

- supporting payment on time, preventing further tax debt from arising;
- providing assistance to those in genuine difficulty; and
- taking effective action against those that fail to engage with us.

5.34 The Government has taken important steps to help prevent debt from becoming part of the tax gap:

- HMRC has offered enhanced access to ‘time to pay’ arrangements through the Business Payment Support Service (BPSS) (see Box 5.7);
- HMRC has made it easier for customers to pay by accepting debit and credit card payment; and
- new legislation has been introduced to align and modernise HMRC’s civil debt enforcement powers.

Box 5.7: Business Payment Support Service

The BPSS was set up by HMRC as part of a package of support for business announced by the Chancellor in his 2008 PBR. This substantial service was quickly established and has given businesses in temporary financial difficulty a fast and streamlined facility for arranging to pay their tax bill to an agreed timetable.

The service has supported over 160,000 businesses, collectively employing more than 1.2 million people. HMRC has agreed repayment arrangements for £4 billion worth of tax. Over £3 billion of this has already been paid in line with agreed instalments, and over 80 per cent of the agreements are for 6 months or less.

The BPSS has been recognised as a service which balances the needs of business with protecting the flow of revenue to the Exchequer. It is flexible and helps viable businesses in genuine need to meet their tax obligations.

HMRC has always offered time to pay in appropriate circumstances and this approach provides a better return to the Exchequer than, for example, forcing an otherwise viable business into bankruptcy or winding up. These arrangements form part of HMRC's long-term strategy for managing payments and debt.

5.35 HMRC is building on these steps with further initiatives, by:

- developing new Payment Plans to allow people to structure tax payments over the course of the year;
- implementing powers to charge penalties for late payments of in-year PAYE from April 2010;
- testing the use of private sector debt collection agencies and the use of new contact methods such as voicemail and text messaging; and
- expanding its telephone capacity to allow earlier contact with debtors.

5.36 Furthermore, PBR 2009 announces:

- a new requirement for businesses asking for 'time to pay' for very large debts over £1 million to provide an independent business review of their needs, ensuring that HMRC can make an informed decision in these few, highly complex cases; and
- the adoption of a consistent approach across all taxes in requiring the collection of debts during ongoing litigation, once a tribunal or court has found against the appellant.

Minimising errors

5.37 The error category comprises of tax losses resulting from basic taxpayer mistakes in preparing in tax calculations, completing returns or in supplying other relevant information. These are errors that are made despite customers taking reasonable care. HMRC estimate that in total errors make up 7.5 per cent of the net tax gap.

5.38 HMRC has several approaches to try and minimise the opportunity for customer error. This approach is designed to:

- make it easier for customers get things right (see Box 5.8);
- provide support and assistance where necessary; and
- work with customers and agents to reduce the number of errors.

Box 5.8: Increasing online services

Lord Carter's Review of HMRC Online Services was published at Budget 2006 and set out specific recommendations to increase take-up of key services and an aspirational goal for HMRC: to aim for universal electronic delivery of tax returns from businesses and IT literate individuals by 2012. HMRC are implementing the recommendations of Lord Carter's review over an extended period to deliver robust, secure, user-friendly online services for HMRC's customers.

A key benefit of these changes for both customers and HMRC is the reduction in error that filing online facilitates. For example:

- some calculations are done automatically for the customer;
- the online form validates that data has been entered in the correct location;
- improved error messages help customers identify problems with their returns; and
- instant updates of electronic guidance means that customers are swiftly informed of relevant information.

Together, these measures are improving data quality, reducing customer error, enabling faster processing for HMRC and reducing the costs of administering tax. The Government estimates that increasing online tax collection will deliver benefits of around £150 million per year to customers and HMRC by 2012.

5.39 In particular, HMRC has:

- reduced the length and detail required to complete tax returns, for example by introducing a short tax return for those with relatively straightforward tax

affairs, and by asking businesses with a turnover below the VAT threshold to only complete a short, three-line account of their profits for tax purposes; and

- reduced the need for manual calculation and the chance of customer error by incorporating automatic checks for online returns and forms.

5.40 HMRC is continuing work to minimise errors, for example by working in partnership with professional advisers and the voluntary and community sector to develop its understanding of how to eliminate errors. HMRC will continue to simplify and improve processes and guidance across all taxes and will continue to work with employers, advisors and other intermediaries to help them get things right now and in the future.

6 Conclusion

6.1 Knowledge of the tax gap, and the behaviours that underpin it, is a vital tool in HMRC's drive to protect tax revenues. For this reason, HMRC will continue to refine the methodologies and improve the data to strengthen these estimates and enhance its understanding of the tax gap.

6.2 As discussed in Chapter 3, the tax gap relating to direct taxes is particularly difficult to estimate due to the difficulty in calculating the theoretical total tax. As a result, no tax authority routinely publishes comprehensive direct tax gap estimates. Good progress has been made, but it should be emphasised that some estimates presented in this document are at an early stage of development. There are also a number of areas where, although work continues, HMRC do not yet possess robust methodologies.

6.3 Future work will aim to improve further the accuracy of HMRC's tax gap estimates. HMRC hopes to improve knowledge of certain hard-to-reach areas - for example by using data matching to track and measure the scale of the hidden economy as wider sources of information become available. Much can be gained by improving links with other research to gain a better understanding of taxpayer behaviour. In addition, as new compliance strategies and tools emerge, they should in turn provide additional data that can inform and improve tax gap analysis.

6.4 HMRC is therefore determined to continue to enhance its understanding of the tax gap and is committed to publishing further estimates of the tax gap as more robust methodologies are developed.