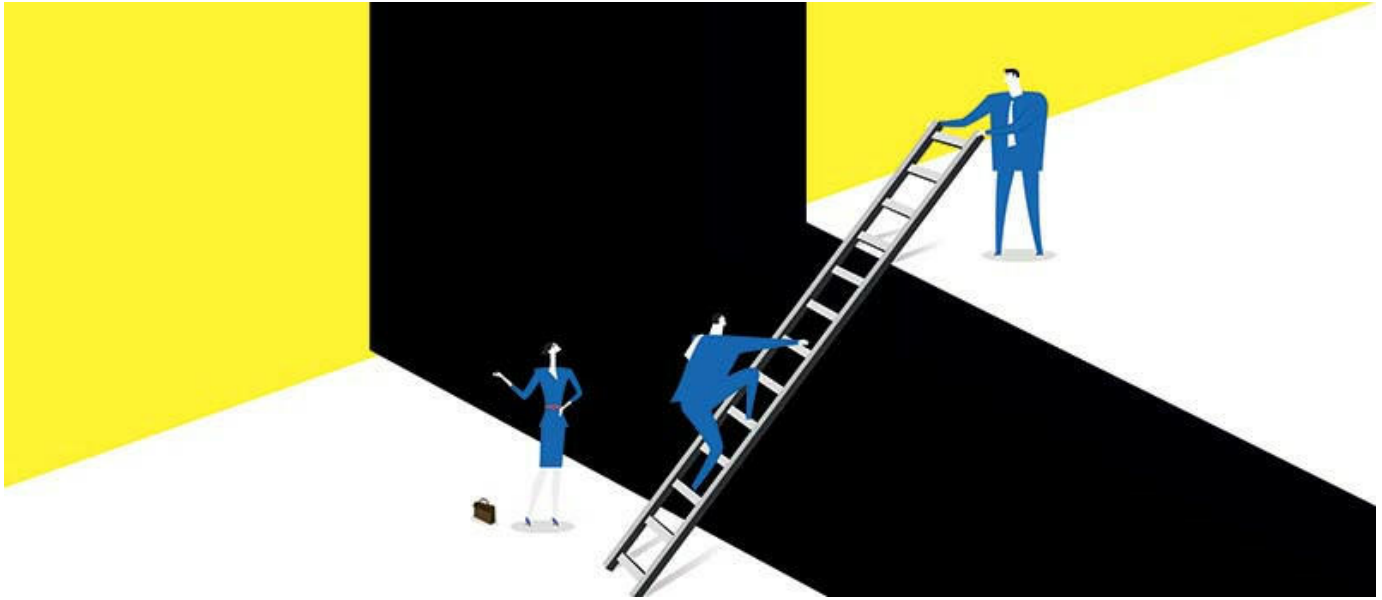


The tax gap between what is paid and what is owed to HMRC

Large Corporate

Management of taxes

OMB



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The tax gap between what is owed to HMRC and what is actually paid remains stubbornly high. We ask what can be done to improve tax compliance.

Key Points

What is the issue?

HMRC estimates that the tax gap between tax due and declared remains stubbornly high, even after excluding Covid-related errors.

What does it mean for me?

HMRC may increase its compliance efforts, making use of its considerable data resources, and consider further legislative changes to close the gap.

What can I take away?

Many areas of tax are complex, so clients will still need advisers who can support and educate them on their obligations and the tax rules, particularly as the scope and involvement in the digital economy grows.

The tax gap is the estimated difference between the amount of tax that should in theory be paid to HMRC and what is actually paid. It remains stubbornly high when reviewed year on year: the most recent published data (July 2022) estimates it at £32 billion for 2020/21 (see bit.ly/3d4L3Mn).

Given the Treasury's need to raise funds, areas highlighted by the tax gap statistics are obvious sources of funds. It is also important, in a fair tax system, that the right amount of tax is assessed and paid by UK taxpayers of all types.

The size of the tax gap

In understanding HMRC's tax gap estimates, there are two material numbers to highlight. Firstly, estimates of Covid-related fraud are published separately (see bit.ly/3vDW91b) and are not part of the main tax gap analysis. Secondly, the total tax debt figure is also materially higher; the amount included in the tax gap is only tax debt written off as uncollectable by HMRC, not unpaid taxes which HMRC thinks are recoverable.

We should always start with some good news: the loss of tax through tax avoidance is low (relative to other sources of errors) and significantly reduced compared to 2005/06. This is just one element of the tax gap, which also includes taxpayer behaviours ranging from non-payment, legal interpretation, error, failure to take reasonable care, tax evasion and the hidden economy.

HMRC estimates that the loss of tax via avoidance is now only 4% of the total (£1.2 billion). It will be interesting to see if this results in less HMRC activity in the future. Success came through a wide range of activities to tackle avoidance promoters, prevent the use of schemes by individuals, and the settlement and litigation of arrangements by HMRC's Counter Avoidance Directorate. This is unsurprising given the plethora of new powers and procedures since 2010, including GAAR, POTAS, enhanced DOTAS, follower notices, accelerated payment notices and a focus on professional standards. And let's not forget the regular publicity to deter the use of

avoidance (including with the Advertising Standards Authority), plus a HMRC litigation success rate exceeding 80%.

The tax gap analysis can also be used to dispel myths. For example, contrary to popular rhetoric that most tax losses are solely or mainly by large multinationals not paying corporation tax in the UK, these statistics tell a different story. The 2020/21 tax gap for income tax, National Insurance contributions and capital gains tax is £12.7 billion – this is the biggest share of the total tax gap when viewed by type of tax (39.5%), with the second largest gap being for VAT at £9 billion (28.0%). Large businesses account for 11% of the tax gap (£3.6 billion). However, in the ‘small print’ it notes that the tax gap excludes BEPS arrangements where they cannot be addressed under UK law, as they need to be tackled multilaterally via countries joining the Multilateral Convention.

Problems paying the right amount tax are shown across all industries and revenue streams. However, small businesses are estimated to be by far the worst offenders – here the gap rose by £500 million. In 2020/21, 48% (£15.6 billion) of the tax gap is attributed to small businesses, whereas ‘wealthy’ customers account for the smallest share at just 5% (£1.5 billion).

So where is the ‘bad news’ or obvious areas of improvement?

Crime and tax evasion

The statistics show that criminal attacks, tax evasion and the hidden economy (individuals or ‘ghosts’ not registered for tax) remain consistently high despite HMRC’s plentiful civil and criminal investigation powers. The combined effect is 41% or £13.2 billion of the 2020/21 tax gap. This is an obvious area for HMRC, especially its Fraud Investigation Service, to tackle. Detailed analysis of data accessible by HMRC and internationally with other tax authorities is crucial to identify such cases.

As commentators have already highlighted, the need to maintain HMRC resources, in particular funding for technology and the training and development of experienced investigators, is part of the solution. Resources should be devoted to publicising tax rules too: for example, HMRC’s recent research indicates that many taxpayers simply do not understand their obligations in relation to cryptoassets, which will contribute to the hidden economy (see bit.ly/3OW5Ajv). Prevention through licensing controls may reduce the hidden economy tax gap: since April

anyone wanting to renew a taxi-private hire or scrap metal licence must complete a formal tax check to prove they are registered as a taxpayer before a licence is issued. New powers to tackle and penalise electronic sales suppression (Finance Act 2022 Sch 14) should also reduce the evasion tax gap over time.

Errors without culpability

The combination of legal interpretation and errors despite taking reasonable care account for £6.7 billion (21% of the tax gap), which is similar to the £6.1 billion caused by careless errors. Despite the Office of Tax Simplification's best efforts, UK tax legislation and guidance remains complex and voluminous. Ultimately, the choices of whether to change rules or offer new reliefs are often down to politics and economics, which often trump simplification.

Access to good quality tax advice for those with complex affairs is a priority. For the unrepresented public, HMRC focuses on guidance and education with more online resources (including YouTube). With Making Tax Digital for income tax on the horizon, making tax administration simpler so that taxpayers can understand what they need to do and when is a priority. It will also be interesting to see whether the new Uncertain Tax Treatment notifications (Finance Act 2022 Sch 17) help to reduce the 'legal interpretation' tax gap for larger corporates.

HMRC needs to ask itself: 'Will our tax system stand up to the intuitive test in a digital world?' The new digital tax account may help some taxpayers to keep up with their tax obligations, but agents need good digital access too. The 'digital world' also presents technical tax challenges, such as the tax rules for cryptocurrencies, digital assets and Decentralised Autonomous Organisations (see bit.ly/3bq1JO2).

Unpaid taxes

The tax gap includes £4.9 billion of tax which HMRC cannot collect, e.g. due to insolvencies. HMRC performance data (outside of the tax gap reporting) highlights that the tax debt balance was £41.6 billion at 31 March 2022 (see bit.ly/3BEFcaW). Given the financial difficulties facing individuals and businesses, personal insolvencies and business bankruptcies may rise and some taxpayers may be unable to pay HMRC.

A sustained focus on support to pay tax debt is needed for the next few years. Over 800,000 businesses and individuals had formal Time to Pay arrangements with HMRC at 31 March 2022. These arrangements to pay taxes, albeit over a longer period of time, should be encouraged where sensible. In addition, HMRC aims to recruit around 2,000 people in 2022/23 to fill existing vacancies and find around 500 additional debt management staff over the next three years. Debt collection and enforcement action against those who are deliberately not paying is increasing post pandemic. Again, HMRC has wide-ranging powers, including enforcement by deduction from bank accounts (Finance (No. 2) Act 2015 Sch 8), its recently revived 'preferential creditor' status, and joint and several liability notices (Finance Act 2020 Sch 13).

Closing the gap

A key question for HMRC and the government is what more can be done to significantly reduce the tax gap. HMRC can use several methods to engage with taxpayers and their professional advisors.

Education and nudge letters

The use of behavioural science and so-called 'nudge letters' to prompt and promote tax compliance remains a 'go-to' strategy for HMRC because of its simplicity. The most prominent campaign (and, in our experience, quite successful) is using Common Reporting Standard (CRS) data to identify and contact taxpayers about undeclared or incorrect reporting of offshore income and gains. HMRC plans to publish a new 'offshore tax gap', estimating the amount of offshore tax not being correctly reported by UK taxpayers next year, for the 'Measuring tax gaps 2023 edition'.

HMRC now issues nudge letters on a wide range of issues, including let properties, P11D discrepancies, deemed domicile status, tax residency, transfer pricing and undeclared property gains. In future, HMRC may issue nudges to a wider range of taxpayers if the OECD's Reporting Rules for Digital Platforms and Crypto-asset Reporting Framework are widely adopted globally.

Nudge letters should impact on the tax gap, although measurement is tricky. Most letters encourage seeking professional tax advice and making disclosures where necessary, although some are purely educational. Inevitably, there remains some

criticism where poorly targeted letters are sent to those with no problems and there is apparent lack of upfront checks against filed tax returns.

Voluntary disclosures

Encouraging taxpayers to make voluntary disclosures should be a 'no brainer' for HMRC in terms of reducing the tax gap. This is far less resource heavy for HMRC, and those minded to disclose voluntarily (or after being nudged) may be more likely to remain tax compliant in future. Further work by HMRC to promote and support taxpayers making disclosures in a user-friendly manner is to be welcomed.

The key campaigns for disclosures include:

- property income and gains via the Let Property Campaign;
- offshore income and gains via Worldwide Disclosure Facility;
- transfer pricing and diverted profits corrections via the Profit Diversion Compliance Facility; and
- tax fraud via the Contractual Disclosure Facility.

Expert tax advice regarding voluntary disclosures should always be sought in advance to decide the most appropriate process based on the specific circumstances of the case.

Encouraging informants

HMRC remains keen to hear from disgruntled employees, property tenants and ex-partners about any suspected tax fraud or avoidance – a tactic used to address furlough fraud. Making whistleblowing more accessible to the general public via online reporting should help to generate more HMRC investigations, if HMRC has the resources to make good use of the information.

Intelligence led tax return enquiries

For small business, cross-tax enquiries are an understandable solution. For businesses where one or more individuals is a controlling director, tax errors in one area may well indicate that many taxes, both business and personal, are also underpaid; for example, where a director uses their Director's Loan Account as a 'money box', or if there are insufficient controls leading to errors in payroll, bookkeeping and personal tax compliance could point to wider problems.

Of course, such enquiries are more resource intensive and must be targeted using intelligence from HMRC's Connect data analytics system, combined with other government and public data to be cost-effective. Unsurprisingly, HMRC is now consulting on collecting more precise information; for example, the job roles of individual employees and SIC codes for self-employed individuals' industry sectors (see bit.ly/3Jsdv6W).

Serious tax investigations

As crime, evasion and the hidden economy comprise a big part of the tax gap, HMRC must focus its efforts on catching those who deliberately evade taxes. This should include those who may not immediately identify themselves as tax evaders (e.g. those using 'old-fashioned' methods to extract cash from businesses or more modern methods using cryptoassets or electronic sale suppression). This essential work stream for HMRC can be measured via the use of Code of Practice 9 (the Contractual Disclosure Facility) for suspected tax evasion, which is traditionally more cost effective in generating yield for HMRC, alongside the more costly, time-consuming criminal investigations for cheating the public revenue, fraudulent evasion and corporate criminal offences.

Complex investigations (e.g. under Code of Practice 8) can be part of the solution too. HMRC will soon get access to Companies House's new register of offshore entities owning UK real estate, in addition to the Land Registry data it already accesses.

Whilst data analysis may identify relatively straightforward cases for which nudge letters may be appropriate, others may involve complex offshore trust structures, corporate residence issues and transfers of assets abroad for which COP 8 could be useful unless serious tax evasion is suspected (for which COP 9 should be used).

Assisting tax compliance

Finally, HMRC and professional advisors' efforts in supporting compliance by taxpayers must be part of any solution to reduce the tax gap. Resources, education, training and awareness remain top priorities for both HMRC staff and the tax profession but over the last ten years many new 'motivations' were put in place for the right amount of taxes to be paid. However, to keep reducing the tax gap, a 'doubling down' of efforts and enforcement is urgently needed by everyone working in tax.