Tackling the tax gap

David Pedley and Sarah Mawson explain what the tax gap is, how it is calculated, and what HMRC is doing to try to reduce it

There is much debate concerning the need to increase public borrowing or taxes due to the impact of the government's response to Covid. In recent days we have again seen calls for the introduction of a one-off UK wealth tax, suggesting a 5% charge on net assets over £500,000 could raise more than £260bn.

Attention has also turned to how much of the current tax take is not collected and how much more efficient HMRC could, or should be, in collecting what is already legislated for, as well as the inevitable speculation as to how HMRC may go about this. But how much more can HMRC realistically achieve?

Last summer, HMRC published the latest edition of their annual 'Measuring Tax Gaps' report, which attempts to quantify the level of unpaid tax liabilities due to the Exchequer each year. They estimate this at £31bn per annum (4.7% of the total tax due). HMRC claim that they have significantly reduced the proportionate amount of tax which remains unpaid each year (they estimate the tax gap was 8.3% of tax due in 2005/06) and that targeted efforts to tackle tax avoidance and evasion are generally succeeding. HMRC claims that this "is the result of sustained efforts by HMRC to… make it as easy as possible for taxpayers to pay the right tax at the right time".

However, the report sets out the methodologies used to arrive at the figures and while it claims to be "a useful tool for understanding the relative size and nature of non-compliance" HMRC accepts that the figures are estimated and that "there are many sources of uncertainty and potential error". They advise the reader to focus on the "trend in the results rather than the absolute numbers".

Various commentors have regularly queried the accuracy of these annual 'tax gap' figures and some believe they are way too conservative and that HMRC could do more to tackle tax evasion and avoidance. A closer look at some of the underlying numbers suggests a mixed picture, with successes in some areas and less so in others. Certainly from our experience, assisting clients subject to HMRC interventions on a daily basis, when it comes to compliance work it often appears that a combination of a lack of appropriate resource, a misdirection of efforts and even the sometimes misguided efforts and tactics of individual HMRC officers are not consistent with the apparent tax gap reduction in certain areas.

For most taxes, HMRC uses yield data accumulated internally from this compliance work and extrapolating figures of additionally due and collectable but unpaid tax from that to calculate these figures. However, the VAT and Excise Duties figure are calculated differently, using consumer data, which produces a higher tax gap figure by comparison. The figures also include estimates of the losses it believes have been restricted, indirectly, due to that compliance activity, as well as the potential impact of this activity and legislative changes on future behaviour. Amounts not collected, including debts written off, are included too, but we know from experience that many of these may either have not been properly due, estimated or unchallenged.

The headline numbers tell us VAT and Corporation Tax are the worst offenders, at 7% as a percentage lost as a proportion of the total tax take. Income tax (IT), NICs and CGT are the highest numerically, at £12.1 billion, but the lowest as a proportion at 3.5%. Remember though that the majority of this is collected via PAYE and a separate figure relating to employers' liabilities is reported as £3bn.

Experience points to smaller employers suffering from a combination of basic payroll errors and under reporting, and larger employers from a combination of challenges to schemes as well innocent non-reporting of the PAYE and NIC on more complex and substantial share arrangements for larger and mid-market employers.

However, we are aware that a number of these type of transaction are not specifically pursued by HMRC or are much more difficult to spot and may remain outside of HMRC's vision.

It also states the "IT, NICs and CGT tax gap estimate as a proportion of total liabilities has stayed broadly stable from the tax years 2005/6 to 2017/18". Given that this is a significant proportion of the total tax gap, and one that sees the focus of a considerable amount of HMRC's compliance activity, this is surprising against the backdrop of the overall decrease in the percentage tax gap that is being lauded by HMRC.

HMRC have begun calculating a specific tax gap figure for the "wealthy" taxpayer population for the first time this year, which they estimate at £1.7bn for the year 2018/19, or 6% of the expected total tax take for this population, one which HMRC appear to be targeting in enquiry work, identifying anybody earning over £200,000 or with assets in excess of £2m.

Despite the claim that the tax gap is narrowing, the report admits that "customer behaviours over the past six years have been broadly consistent", and also "the breakdown of the tax gap by customer group over the past five years has been broadly stable". This is true, for example, in relation to the hidden economy and the activities of 'ghosts' and 'moonlighters', with an estimated figure of £1.9bn.

However, a recent news report claimed the Bank of England is unaware of the location of £50bn worth of currency, essentially cash, notes and coins not held in bank accounts, but presumably held in person (in piggy banks or stuffed under mattresses, perhaps) overseas or in circulation in the shadow economy. The Bank was criticized by the Public Accounts Committee for being unaware of where this money is and it is estimated that this is three-quarters of the total of all banknotes in circulation and has increased due to greater demand, despite little apparent cause and cash being less widely used. Is the informal cash economy thriving despite HMRC's claim that they are tackling tax evasion?

HMRC's explanation for a smaller VAT gap appears to imply growth in the economy, and therefore in total VAT receipts is a reason for the decrease. This would, in turn, imply that there is no consistent level of error, avoidance and/or evasion within that growth as within the taxpayer population pre-growth.

The one area where there has been a significant reduction (£3.7 billion in 2005 to 2006 to £1.7 billion in 2018 to 2019) is in tax avoidance. This is defined as that which would be due by reference to the letter of the law and "our interpretation of Parliament's intention". This could equally be seen as the result of the introduction of retroactive and targeted legislation and Court decisions favourable to HMRC as much as their own compliance activity. And when it comes to evasion, the report credits the introduction of Making Tax Digital as seeking to reduce the tax gap caused by error and failure to take reasonable care.

When it comes to interventions, does HMRC have the resources to engage effectively in a targeted and efficient way? In the past, extra funding has been given to HMRC to specifically undertake enquiries and it is widely believed that for every £1 HMRC spends on compliance work it collects more than this as a result.

Given the need to raise funds for the Exchequer, HMRC will inevitably continue to re-focus their compliance efforts. Our experience allows us to identify taxpayer population groups that are likely to come under more intense scrutiny by HMRC in the near future. For example, High Net Worth Individuals, employers and corporates trading overseas.

HMRC have access to a vast amount of data due to increased information gathering powers and use of technology. But resources do not appear to allow them to fully use this. As a result, we expect more 'broad brush' interventions, such as the issuing of so-called 'nudge letters' – mass mailings of large number of taxpayers from that harvested data, contacted and asked to self-review and consider filing a disclosure.

While this approach is regarded as efficient and wide ranging in terms of potential results by HMRC, our experience is that it is not sufficiently targeted and too scatter-gun. We have seen instances of letters issued inappropriately or unwarranted because HMRC do not appear to always, or even often, routinely compare or cross-refer information with individual taxpayer's returns. This can often cause clients undue stress and expense in having to deal with the consequences of satisfying HMRC of their error.

This type of broader, risk-based approach has also had, along other practices such as the routine transferring of experienced investigators away from specialist teams and frontline investigation work, has led to a less critical and detailed approach relying more on taxpayers. With the help of their advisors, they are undertaking more of the work themselves in either disclosing, or alternatively demonstrating the lack of, errors. The use of these blunt instruments in compliance work are likely to continue.

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