HM Revenue & Customs

The tax gap and compliance yield – what they are and how they relate

Summary

The tax gap is the difference between the amount of tax that should, in theory, be collected by HM Revenue and Customs (HMRC) against what is actually collected. The amount of compliance yield HMRC generates and the size of the tax gap are related but the links are not straightforward.

Compliance yield records many aspects of compliance work, including tax recovered directly from our work, future revenue benefit and losses prevented. It can also cover more than one tax year. Different factors, such as the number of new businesses, new customers, changes in levels of voluntary compliance, economic factors, tax policy and rate changes all affect the tax gap.

Because the tax gap reflects a single year, and some compliance cases can cover multiple years, it is possible that the amount of compliance yield HMRC secures might increase while the percentage tax gap remains the same or reduces.

The tax gap

The tax gap provides a useful tool for understanding the relative size and nature of non-compliance. HMRC publishes an estimate of the tax gap each year. Tax gap estimates are calculated net of compliance yield; i.e. they reflect the gap remaining after HMRC compliance efforts.

Although international tax gaps are not directly comparable due to different tax policies and methodological differences, of those published, the UK's tax gap is one of the lowest in the world and the only one covering direct and indirect taxes that is measured and published every year.

The latest estimate, for 2014-15, shows an overall downward trend as the percentage tax gap reduced from 8.3% in 2005-06 to 6.5% in 2014-15, however the tax gap has levelled out in recent years.

The tax gap, described as a percentage of total tax liabilities that should in theory be collected, provides a better insight into changing compliance levels. This is because it takes account of some of the effects of inflation, economic growth and changes to the tax rates, as well as changes to tax compliance where the cash figure does not.

Further information about the tax gap can be found at:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/561312/HMRC-measuring-tax-gaps-2016.pdf

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/561314/HMRC-measuring-tax-gaps-2016-methodological-annex.pdf

Compliance yield

HMRC's compliance yield amounts to billions of pounds that would have otherwise been lost to the UK. We have strengthened our grip on those who deliberately cheat the system through fraud, avoidance and evasion, and continue to pursue those who refuse to pay what they owe. We apply the most appropriate civil and criminal sanctions to this dishonest minority. The decision to carry out a criminal investigation is based on a number of factors, for example the nature and scale of the alleged fraud or our ability to obtain evidence to prove the case.

Compliance yield includes not only cash expected but also an estimate of the amount of revenue we prevent from being lost, together with the impact of legislative changes, process improvements and our current compliance activity on future customer behaviour. Compliance yield also captures the impact of the Accelerated Payments regime, which requires individuals or businesses involved in specific tax avoidance schemes to pay the disputed amount of tax up front, so they do not benefit from keeping the money while sometimes lengthy legal proceedings take place.

Compliance yield targets are now set on an annual basis at Budget. The 2016-17 target was announced in the March 2016 Budget.

The main components of our compliance yield are:

- **Cash expected** – the amount of additional revenue due when we identify past non-compliance, reduced by a discount rate to reflect the fact that some of the amounts that we identify will not be collected, for example where a business subsequently becomes insolvent. While the amount of tax due from these cases is very clear, we cannot trace every compliance assessment through to final payment so there is an element of estimation involved in this figure.
- **Future revenue benefit** – the estimated effects of our compliance interventions on customers' future behaviour. In July 2016 we published a technical paper setting out the changes we were making to the reporting of future revenue benefit.
- **Revenue loss prevented (RLP)** – the value of our activities where we have prevented revenue from being lost to the Exchequer that impacts on our tax receipts. Where we stop or reduce repayments claims as a result of error or fraud, we have a high level of certainty over the RLP generated. Whereas quantifying the RLP generated from disrupting criminal activity requires a greater level of estimation.
- **Product and process yield** – the estimated annual impact on net tax receipts of legislative changes to close tax loop holes and changes to our processes which reduce opportunities to avoid or evade tax. This estimate is subject to independent scrutiny by the Office for Budget Responsibility.
- **Accelerated Payments** notices – the disputed amounts of tax that people using tax avoidance schemes are now required to pay up-front within 90 days, as well as an estimate of the behavioural change that the policy has generated.

These components and their relation to the tax gap are explained further in the pages that follow.

Compliance activities and how these map to the tax gap

We undertake a wide range of activities that contribute to our compliance results. The table below illustrates the types of work that are recorded under each component of compliance yield and outlines how these map to the tax gap.

Compliance activity	Illustrative Example	How this component maps to the tax gap
Cash expected	HMRC investigates a company's tax return and discovers that they have under-declared profits. HMRC concludes the company should pay an additional £2 million in Corporation Tax for each of the previous three years. As a result the company agrees the outstanding tax bill of £6 million along with interest and penalties of £1 million – HMRC records this as **£7 million cash expected**. HMRC accepts that not all of the additional cash expected identified and agreed will be paid, due to insolvency for example, so applies a **discount rate** to the total cash expected. The **total value of the discount** is an estimate due to the difficulties HMRC would face in tracking all the payments made against all its compliance interventions.	The cash expected element of compliance yield represents additional liabilities due which arise from investigations into past non-compliance. Cash expected is tax gap closing and is part of the tax gap calculation for some but not all of the tax gap components. The year in which cash expected is generated and recorded for compliance yield is not always the same as the year to which liabilities relate. Cash expected in any year can cover multiple past years' liabilities. Tax gap estimates are based on the year of liability, so there is not a one-to-one link between published cash expected figures and the tax gap.

Compliance activity	Illustrative Example	How this component maps to the tax gap
Future revenue benefit (FRB)	Continuing the example above, the company puts in place a new accounting system to get its tax return right and prevent the same issue occurring in future. This leads to the company paying an additional £2 million in each year. HMRC will record this improved behaviour for the next two tax returns and records this as a further **£4 million of future revenue benefit**. Under HMRC's new approach to future revenue benefit reporting, the figure of £2 million future revenue benefit would be recorded in each of the following two years. This differs from the previous methodology where the £4 million future revenue benefit would have been recorded in the year the compliance investigation was closed alongside the £7 million cash expected.	As FRB reflects a customer's future compliance behaviour, it is not explicitly reflected in the calculation of tax gap estimates. However, if HMRC did not affect customers' future behaviour, the tax gap would be larger.

Compliance activity	Illustrative Example	How this component maps to the tax gap
Revenue loss prevented (RLP)	<u>Stopping or reducing claims to repayment made through error or fraud:</u> A business makes a claim for a repayment of £250,000. The repayment claim is selected for review. It is established that an invoice has been included which was for £100,000 against business entertainment, upon which VAT cannot be recovered. Therefore reducing the repayment claim buy £100,000. This results in **revenue loss prevented of £100,000** as VAT was claimed by the business but HMRC did not make the repayment. <u>Disrupting criminal activity:</u> HMRC provided intelligence leading to the identification and dismantling of an overseas cigarette factory used by organised criminals to target the UK. More than 22,000 kilos of tobacco and 2.5 million cigarettes were seized. In total HMRC reported **revenue loss prevented of £82.2 million**, the equivalent of one year's production (based on a 60% efficiency rate in the factory.)	RLP represents cases where HMRC has refused fraudulent or incorrect repayment claims or has disrupted criminal activity, for example seizures of illicit alcohol or tobacco. RLP activity is broadly preventing growth in the tax gap. An increase in RLP can indicate that HMRC is having to do more to maintain the tax gap at its current level. RLP is not reflected in the tax gap calculation. However if HMRC were not generating RLP, the tax gap would be higher.
Product and process yield (P&P)	HMRC identified a specific area of potential avoidance in plant and machinery leasing where tax relief could be claimed more than once. HM Treasury and HMRC worked together to put in place legislation that put beyond a doubt that tax relief would only be available up to the value of the transaction. HMRC claimed **£130 million in product and process yield** which would have been lost to the Exchequer in 2015-16 if the avoidance opportunity had not been closed.	P&P is an increase in tax receipts from legislative changes to reduce opportunities for fraud and avoidance and educational activity to reduce errors. It is tax gap closing activity, however it is not explicitly reflected in tax gap estimates. The P&P that we report relates to the year in which tax receipts are increased, which is similar but not exactly the same as the year in which the liability arises.

Compliance activity	Illustrative Example	How this component maps to the tax gap
Accelerated Payments (AP)	<u>Before AP legislation came in</u> Alan invests in an avoidance scheme and claims £150,000 in tax relief which HMRC disputes. Alan holds onto this money during the process of investigating and litigating the use of the scheme. This process takes many years and Alan is incentivised to keep challenging the scheme in court as he remains in possession of the disputed relief. Following wins at tribunal, HMRC win at the Court of Appeal and Alan repays the relief plus interest. HMRC records the yield on conclusion of the case. <u>With AP legislation in place</u> Alan invests in an avoidance scheme and claims £150,000 in tax relief which HMRC disputes. An Accelerated Payments notice (APN) is issued to Alan for the amount of disputed tax. The APN is paid and HMRC score the **£150,000 as compliance yield** but Alan chooses not to settle and to continue disputing the tax that is due, pushing the case to litigation. After HMRC wins at the First Tier Tribunal, Alan concedes. As Alan had paid the APN he does not now need to repay the tax **but he pays the interest which is due**. There has been no cash flow advantage as Alan paid his disputed tax up front, just like the vast majority of taxpayers. HMRC records the yield upon receipt of the accelerated payment.	This component was introduced in 2014-15. Since then, the AP yield we have generated closes tax gaps from previous years. Indeed, APNs may cover many past years. At final settlement the activity is tax gap closing and will affect past years' liabilities. AP also reduces the incentive for customers to enter new avoidance activity in future years. The behavioural impact of AP affects current and future years' liabilities. Neither aspect of AP yield is included explicitly in the tax gap calculations. If HMRC loses its argument, the AP is repaid. In these instances there is no impact either way on the tax gap for the years previously in dispute.