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REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

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HM Revenue & Customs

Tax avoidance: tackling marketed avoidance schemes

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National Audit Office

HM Revenue & Customs

Tax avoidance: tackling marketed avoidance schemes

Report by the Comptroller and Auditor General

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This report examines the effectiveness of the DOTAS regime and HMRC's response to marketed tax avoidance schemes, particularly those used by large numbers of individuals and smaller businesses.

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Contents

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This report can be found on the National Audit Office website at www.nao.org.uk/tax-avoidance-2012

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Key facts

£10.2bn

HMRC's estimate of the tax at risk from avoidance schemes it is investigating that are used by individuals and smaller companies

41,000

open avoidance cases relating to individuals and smaller companies

£5bn

annual tax gap attributed to avoidance

86 per cent	HMRC success rate at court in avoidance cases in 2011-12
324	number of different avoidance schemes whose use was disclosed on tax returns received in 2011-12
2,289	total number of tax avoidance schemes disclosed by promoters between 2004-05 and 2011-12

Summary

1 Part of HM Revenue & Customs' (HMRC's) vision is to close the tax gap, the difference between the tax that is collected and the tax that should be collected. HMRC estimated the tax gap in 2010-11 to be £32 billion, of which £5 billion was due to avoidance.

2 HMRC's working definition of tax avoidance is 'using the tax law to get a tax advantage that Parliament never intended'. Unlike tax evasion which involves fraud or deliberate concealment, tax avoidance is not illegal. However, it often involves contrived, artificial transactions that serve little or no purpose other than to produce a tax advantage.

3 HMRC has a strategy to prevent, detect and counteract avoidance. An important part of this strategy is a disclosure regime, known as DOTAS (Disclosure of Tax Avoidance Schemes). This regime requires those that design and sell certain types of tax avoidance scheme (the 'promoters') to tell HMRC about each new scheme they introduce. HMRC issues a scheme reference number which taxpayers who have used the scheme must then record on their tax return.

4 Not all tax avoidance needs to be disclosed under DOTAS. Initially, only two types of scheme which HMRC judged to be particularly high risk had to be disclosed. DOTAS has been expanded over time to include more taxes and more types of avoidance.

The scope of this report

5 This report examines the effectiveness of the DOTAS regime and HMRC's response to marketed tax avoidance schemes, particularly those used by large numbers of individuals and smaller businesses. It responds to parliamentary and public interest in schemes used by affluent individuals to significantly reduce their tax bills. The NAO and the Committee of Public Accounts have reported separately on tax settlements with large companies. The Committee also reported in October 2012 on the use of off-payroll arrangements as a means to reduce tax obligations in the public sector.

Key findings

The effectiveness of the DOTAS regime

6 **By providing early warning of avoidance schemes, DOTAS has helped HMRC to recommend changes to tax law and prevent some types of avoidance activity.** DOTAS has enabled HMRC to inform legislation to close legal 'loopholes' more quickly and to recommend more fundamental changes to tax law to tackle particular types of avoidance scheme, though it has not stopped some promoters from marketing new schemes designed to work around revised legislation. Since the introduction of DOTAS in 2004, HMRC has initiated 93 changes to tax law designed to reduce avoidance (paragraphs 2.5–2.6).

7 There continues to be an active market of tax avoidance schemes, though the shape of the market has changed. Over 100 new avoidance schemes have been disclosed under DOTAS in each of the last four years, many of them involving variations on themes as promoters respond to changes in tax law. There is no evidence that the use of such schemes is reducing. However, most tax practitioners and experts we consulted said that changes to tax law had reduced the opportunities for avoidance and that the larger accountancy firms, for example, were now less active in this area. They told us that most schemes were now promoted by small specialist tax advisers, some of whom had a business model that relied on helping their clients avoid paying tax. Our analysis of DOTAS disclosures since 2004 supports the view that the market has changed in this way. HMRC believes that most of the marketed schemes now promoted won't work – that is, they would be defeated if tested in the courts, and any tax advantage accrued by the schemes' users would have to be repaid – but it can take HMRC many years to prove this (paragraphs 2.5, 2.14, 2.15 and 2.16).

8 HMRC has been unable to enforce compliance with DOTAS on those promoters determined to avoid disclosure. Most promoters comply with DOTAS, but a minority will go to some lengths to avoid disclosing a scheme if they perceive an advantage in doing so. There are penalties for promoters who fail to disclose a scheme under DOTAS. However, where a promoter has obtained a legal opinion that a scheme does not require disclosure, it can claim this represents 'reasonable excuse' and no penalty is applicable. Since September 2007, HMRC has opened 365 enquiries where it suspected a promoter had not complied with the disclosure rules, in most cases concluding that there had been no failure to comply. It has applied 11 penalties over that time, each of £5,000 (paragraphs 2.21–2.23).

9 The government is considering how it could strengthen DOTAS, including HMRC's powers to enforce compliance. It is consulting on widening the information which promoters are required to disclose under DOTAS and on how it could change the rules to raise the hurdle for reasonable excuse (paragraphs 2.22–2.23).

10 HMRC has ways of detecting avoidance activity other than through DOTAS, but has not estimated how many schemes that should be disclosed under DOTAS are not. HMRC uses risk assessment to detect avoidance activity that either falls outside of the DOTAS rules or that should be disclosed but isn't. It believes that by assigning a relationship manager to the largest businesses and wealthiest individuals, it has reduced the risk that avoidance goes undetected. However, HMRC has not sought to estimate the level of non-compliance with its disclosure rules (paragraphs 2.18–2.21).

HMRC's response to marketed avoidance schemes

11 **HMRC has not yet found an effective deterrent to prevent promoters from marketing aggressive schemes.** As avoidance is not illegal, HMRC does not have powers to prohibit promoters from designing and marketing schemes. It has identified several hundred entities that have promoted or sold avoidance schemes since DOTAS was introduced, and believes that there are currently between 50 and 100 active promoters. However, HMRC has not sought to build a detailed picture of the way the market operates. HMRC is consulting on how it might extend its powers to help it influence the behaviour of scheme promoters, and is piloting ways to discourage promoters from marketing aggressive schemes using its existing powers (paragraphs 2.12–2.17).

12 **HMRC has increased its focus on the tax affairs of high net worth and affluent individuals.** In response to what it perceived as a heightened risk, in 2009, HMRC set up a high net worth unit, which employs 390 staff, to deal with individuals who have assets of more than £20 million. In 2011-12, it estimated that the unit achieved £200 million of revenue that would otherwise have been lost, including through avoidance. In 2011-12, it also set up a unit to deal with 'affluent' individuals; those who pay tax in the 50 per cent bracket or who have assets of at least £2 million (paragraphs 1.18–1.21).

13 **HMRC has 41,000 open avoidance cases relating to marketed schemes used by small businesses and individuals, and has yet to demonstrate whether it can successfully manage this number down.** HMRC monitors the progress of its projects to investigate similar cases. However, it does not have trend data on the total number of open cases, and has not modelled how its ongoing interventions can be expected to impact on the number of enquiries it has open. HMRC cannot therefore demonstrate whether in aggregate its interventions are effective. It believes that its Managing Avoidance Risk project will give it the information it needs to monitor avoidance cases at a strategic level in future (paragraphs 3.2–3.3).

14 **The large number of users of mass marketed schemes presents a challenge to HMRC.** HMRC estimates there are 30,000 users of partnership loss schemes and employment intermediary schemes. It has sought to tackle such schemes by litigating a few 'lead cases' in order to demonstrate to other users that the scheme will not succeed, but is not always able to apply these rulings to other cases. To address this, it has sought to apply tribunal rules that bind similar cases to the ruling in lead cases (paragraphs 3.12–3.13).

15 **HMRC's investigations into the use of avoidance schemes can take many years to resolve.** It is inherently difficult for HMRC to stop tax avoidance as it is not illegal; a potential avoider can use a scheme to gain a tax advantage until such time as HMRC can prove the arrangement does not work under the law. The evidence to demonstrate that a scheme does not work can take several years to collect, and cases often have to be decided by litigation. Having identified a scheme, HMRC usually has to wait for the scheme users' tax returns – which can be over 18 months later – before it can investigate properly (paragraphs 3.4–3.7).

16 When HMRC litigates against tax avoidance schemes it achieves a high success rate. Since April 2010, litigation has begun on 110 avoidance cases. Judgments on 60 cases have been made and HMRC has been successful in 51 of these. HMRC cannot currently demonstrate that this level of litigation provides an effective deterrent, or that its approach of relying on lead cases is efficient and effective (paragraphs 3.12–3.13).

HMRC's wider strategy for tackling avoidance

17 HMRC has an anti-avoidance strategy, but has not yet identified how it will evaluate its effectiveness. HMRC's anti-avoidance strategy was published in March 2011 and includes a set of actions which HMRC considers to be the most effective at combating avoidance. However, the overall strategy has yet to be evaluated and HMRC is still considering by what means it will assess the strategy's success (paragraphs 1.16–1.17 and 1.22).

18 HMRC does not monitor the costs of its work to tackle avoidance. HMRC's approach is to identify and respond to all the risks it identifies to the effective collection of tax. Investigations into suspected non-compliance may or may not reveal that avoidance has taken place, or may uncover evidence of illegal tax evasion rather than avoidance. HMRC therefore does not collect management information on the resources it commits to tackling avoidance specifically. This limits its ability to make informed decisions about how it should best allocate resources to maximise its impact (paragraph 1.18).

19 The government is considering legislative change that may help to reduce tax avoidance. Ministers have accepted the recommendation of an independent review that a general anti-abuse rule should be introduced. This may help to combat aggressive avoidance schemes, though at this point it is unclear what impact it will have. HMRC is evaluating the impact of the proposed rule on tax revenues, and its estimate will be assured by the Office for Budget Responsibility and then published (paragraph 1.23).

Conclusion on value for money

20 It is inherently difficult for HMRC to stop tax avoidance as it is not illegal. A potential avoider can use a scheme to gain a tax advantage until such time as HMRC can prove that the arrangement is not consistent with tax law; a resource-intensive process which can take many years and often requires litigation.

21 Having introduced its disclosure regime in 2004, HMRC has made some important headway by closing legal loopholes and reducing the opportunities for avoidance. This changed the shape of the market, but has not prevented some promoters from continuing to sell highly contrived schemes to large numbers of taxpayers, depriving public finances of billions of pounds. There is little evidence that HMRC is making progress in addressing this problem and it must now be vigorous in seeking more effective counter-measures, proposing legislative change where necessary.

22 HMRC does not monitor the costs of its anti-avoidance work and has not yet identified how it will evaluate its overall anti-avoidance strategy. This reduces its ability to make informed decisions about where it should direct more effort, and how to best reduce the 41,000 open avoidance cases. HMRC cannot therefore demonstrate that its strategy to tackle marketed tax avoidance schemes provides value for money.

Recommendations

Influencing the market

a **HMRC should increase its efforts to understand and influence the market of promoters of avoidance schemes.** It should analyse the economics of promoting and operating avoidance schemes, the incentives and potential disincentives for promoting schemes, and the types of interventions that could change behaviour. HMRC should use this analysis to inform its approach to influencing the market.

b **HMRC should act on the results of its ongoing consultation to strengthen its powers to enforce compliance with DOTAS, including its ability to apply penalties to those who don't comply.** It should develop and implement a plan to enforce the regime more effectively. It should also estimate and monitor what proportion of schemes that should be disclosed by promoters are not.

Improving management information

c **HMRC should monitor its progress in addressing the stock of open avoidance cases and set out how it will reduce it.** HMRC should collect and analyse management information on all its open cases, including turnover and age profile, and should model the impact of different strategies to reduce their volume.

d **HMRC should create a qualitative framework to evaluate the success of its anti-avoidance work.** When it updates its anti-avoidance strategy, it should map its actions against the strategy's objectives, including how its different activities interact. It should develop the performance measures to help it to judge the strategy's success.

e **HMRC should improve its management information and its costing to better direct its anti-avoidance effort.** Although HMRC records and uses information on costs and additional revenue across its business, it cannot do so specifically for its anti-avoidance work. Therefore it cannot show it is achieving the most effective return for its effort. HMRC should consider time recording or other means to capture the costs of anti-avoidance work, and should monitor these costs against the amount of tax the work protects.

Part One

Introduction

The nature of tax avoidance

1.1 There is no statutory definition of tax avoidance and its boundaries are not always clear cut. HMRC's working definition of tax avoidance is 'using the tax law to get a tax advantage that Parliament never intended'. Avoidance often involves contrived, artificial transactions that serve little or no purpose other than to produce a tax advantage. It is distinct from tax planning where Parliament did intend there to be a tax advantage; and from tax evasion, which is illegal and involves fraud or deliberate concealment (**Figure 1**).

Figure 1
Definition of tax avoidance

Tax avoidance is different from tax planning, legal interpretation and evasion although the boundaries are not always clear

Category	Definition	HMRC's Estimate of tax lost in 2010-11[1]	Examples
Tax planning	Using a tax allowance for the purposes intended by Parliament	None	Use of an Individual Savings Account; transfer of wealth or assets between spouses
Legal interpretation	A difference of opinion between HMRC and the taxpayer over the application of tax law to specific, often complex, transactions	£4 billion	Different opinions over the allocation of profits within a group of companies
Avoidance	Using the tax law to get a tax advantage that Parliament never intended	£5 billion[2]	Individuals receiving income as a non-repayable loan to avoid income tax
Evasion	Illegal activity. Deliberately omitting, concealing or misrepresenting information, to fraudulently obtain a tax advantage	£4 billion	Deliberate understatement of tax liability

NOTES
1 HMRC estimate the total tax gap to be £32 billion for 2010-11. The other categories contributing to the tax gap include error, non-payment, failure to take reasonable care, the hidden economy and criminal attacks.
2 £2.1 billion of this is avoidance of income tax, national insurance contributions, and capital gains tax.

Source: HM Revenue & Customs, Measuring tax gaps 2012, 18 October 2012

1.2 Where HMRC and the taxpayer disagree on whether arrangements are consistent with tax law, it is for the Tax Tribunals and then on appeal, the higher courts to decide. The way the courts interpret tax law has changed over time. Early tax cases adopted a literal approach to interpreting tax law and the *Duke of Westminster* case in 1936 set out a principle that people were entitled to arrange their tax affairs to minimise their tax liabilities.[1] Over the years the courts have developed a more 'purposive' approach to interpreting legislation under which they look at the context of a particular statutory provision in terms of the purpose of the statute as a whole. This approach uses the concept of the intention of Parliament, but what the case law means by that term is what can be found in the statute itself, with only very limited consideration of external materials. This can produce results which even the Judges acknowledge cannot have been intended by Parliament, on a wider view of that concept.[2]

1.3 Important decisions that have shaped how tax law is interpreted are shown in **Figure 2**.

Figure 2
Key rulings on tax avoidance

The way courts approach tax avoidance has evolved over time

Case	Date	Principles established
IRC v. the Duke of Westminster	1936	People are entitled to arrange their tax affairs to minimise their tax liabilities.
Ramsay v. CIR	1981	The Court can look at the transaction in context, especially if it is part of a series of transactions, or as an ingredient of a wider transaction intended as a whole.
Barclays Mercantile Business Finance Limited v. Mawson	2004	Underlines that the Ramsay principle is a principle of statutory interpretation. The Courts must consider "whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction viewed realistically".

Source: Academic research commissioned by the National Audit Office

1 *IRC v. The Duke of Westminster,* 1936.

2 See for example, *Mayes v. HMRC, 2011*, where Lord Justice Thomas found in favour of the taxpayer, but concluded: "…my concurrence is reluctant. The … taxpayers.. have received benefits that Parliament cannot possibly have intended…".

1.4 HMRC has identified a number of 'signposts' that indicate that avoidance may be taking place.[3] These include transactions or arrangements that:

- have little or no economic substance;
- bear little or no pre-tax profit but rely on anticipated tax reduction for significant post-tax profit;
- exhibit little or no business or commercial driver; or
- involve contrived, artificial or commercially unnecessary steps or transactions.

1.5 When HMRC believes that an arrangement exploits tax law in a way that was not intended, it can:

- challenge the scheme on technical grounds by showing that the taxpayer's interpretation is invalid, if necessary pursuing the case through litigation. In this case, the Tax Tribunals and, if appealed, the courts interpret tax law; and/or
- advise government on changes to tax law to prevent the avoidance scheme from working.

Marketed tax avoidance schemes

1.6 Marketed tax avoidance schemes are those that may be sold to one or more individuals or companies. Those buying the scheme will hope to benefit from the tax advantage the scheme offers.

1.7 In describing marketed schemes, the following definitions found in this report are commonly used:

- scheme user – the individual or company seeking to obtain a tax advantage; and
- scheme promoter – the individual or company that designs, markets and implements the scheme. Promoters are tax advisers, accountants, solicitors, and financial institutions, and small firms of specialist promoters, often described as 'tax boutiques'.
- introducer – an individual or company that markets and sells the scheme on behalf of the promoter. Introducers are not responsible for disclosing the scheme to HMRC.
- intermediary entity used in scheme – a vehicle used as part of the structure to effect the scheme.

1.8 Scheme promoters charge the taxpayer a fee for using the scheme to cover their costs and generate profit, and there is often a minimum level of income required to participate in a scheme.

1.9 Marketed schemes are available for a range of transactions and taxes. Schemes can be used to avoid tax on one-off transactions, such as buying property, or may be used for several years. HMRC keeps a register of the main types of avoidance scheme on the basis of the tax at risk. **Figure 3** describes the five largest types of widely marketed scheme, with HMRC's estimates of the tax at risk and number of users, based on its ongoing enquiries and analysis of tax returns.

3 The full list, with examples, is available at: www.hmrc.gov.uk/avoidance/aag-risk-assessing.htm

Figure 3

The five largest types of mass marketed tax avoidance schemes

The high number of users of the largest schemes presents a challenge for HMRC

Type of scheme and how it works	Estimated tax at risk (£m)[1]	Number of users
Partnership loss schemes		
A partnership is set up, which makes a loss. The participants in the partnership use the loss to shelter their other income from tax. The loss created is in excess of the amount invested by the participants. This is achieved by artificially inflating the loss, for example by using loans which are circular, or deferred expenditure, which is never incurred. HMRC has identified 82 variants of this scheme, including film partnership schemes.	3,500	14,000
Employee benefit trust schemes		
Employee benefit trusts are trusts set up by employers to reward or incentivise employees. They can be used to disguise employment income to avoid tax and National Insurance contributions. For example, a trust is set up offshore and makes loans to employees, which are not taxable. In practice, the loans are never repaid and are used as a way of rewarding employees. HMRC has identified 75 variants of this scheme.	1,700[2]	3,400
Interest relief schemes		
Schemes which seek to engineer a situation where a taxpayer can claim interest relief as a deduction against their general income. They evolved when legislation was brought in in March 2007 to counteract partnership loss schemes.	1,100	900
Employment intermediary schemes		
An intermediary (which could be a company, partnership or sole trader) is set up to pay contractors or employees working for a company in the UK. Instead of paying the worker directly, the company using the worker's services pays the intermediary. The intermediary then pays the worker a small salary on which PAYE and National Insurance contributions are paid. It pays the remainder to the worker via interest-free loans, but the loans are never recalled.	600	16,000
Stamp Duty Land Tax schemes		
These schemes take advantage of sub-sale relief. A property sale is structured so that tax relief can be claimed because it is contractually going to be passed on via a connected party. The transaction is structured such that another relief can be claimed, or a low-value transfer can be arranged, when the property is passed on.	500	6,600

NOTES

1 The estimates of tax at risk and number of users are based on quarterly returns from HMRC's project managers overseeing the enquiries into the schemes in summer 2012. The figures exclude schemes which are used by large businesses.

2 Figures in respect of employee benefit trust schemes are currently under review.

Source: HM Revenue & Customs

1.10 Scheme promoters often respond rapidly to changes in tax law, or court decisions. Promoters may redesign schemes to get around anti-avoidance rules or use new tax reliefs. Similarly, they may redesign schemes to take advantage of an adverse court ruling for HMRC, or in response to a court decision that a scheme does not work.

1.11 Many wealthy individuals own, or own a stake in, a business or businesses, and/or belong to a partnership. As well as participating in schemes to reduce their liability to personal taxes, wealthy individuals may use schemes that reduce the tax liability of their business.

1.12 Not all tax avoidance is done through marketed schemes. Large companies executing complex transactions are more likely to design their own ways to minimise tax, tailored to their circumstances. They do not usually sell these schemes to others, although different companies may independently design similar schemes. Most of the tax at risk from large businesses is through customised tax arrangements, rather than widely marketed schemes. These arrangements equally represent a risk that extra tax is due, but in this report we have focused on how HMRC tackles mass marketed schemes.

The scale of avoidance activity

1.13 When HMRC discovers a risk of non-compliance, including avoidance, it estimates the tax at risk. Tax at risk is HMRC's estimate of the extra tax that could be due on the basis of available evidence at that point in time. The amount of extra tax found to be due at the end of an investigation once all the evidence has been collected could be substantially different, and it could be that no extra tax is found to be due.

1.14 Classifying a tax risk often requires a judgement about whether it is likely to be avoidance, a difference about the interpretation of legislation, or evasion. It may not be clear until a late stage whether the risk being investigated can be classified as an avoidance risk. HMRC therefore cannot identify precisely how much tax is at risk due to avoidance. It estimated that at 31 March 2012 up to £35 billion of tax was at risk or under consideration due to avoidance or legal interpretation, covering all taxpayers and all tax years up to that date.[4] Within this total, HMRC estimated that the amount at risk from large businesses had fallen over the preceding year, but that the avoidance risk from smaller businesses and individuals had risen to £10.2 billion (**Figure 4**).

1.15 HMRC acknowledges that its estimate of tax at risk understates the true scale of avoidance, because it is based only on the avoidance risks that HMRC has identified. In estimating some elements of the tax gap (the difference between the tax that is collected and the tax that should be collected), HMRC applies an uplift to reflect the proportion of avoidance activity that it considers goes undetected. HMRC is also planning to use a sample of enquiries into the tax affairs of wealthy individuals to estimate the extent to which avoidance risks are undetected.

4 This estimate includes £19.8 billion of 'tax under consideration' in cases managed by HMRC's Large Business Service, which includes a range of tax risks including avoidance. It includes a further £4.8 billion of tax risk relating to large and complex businesses.

Figure 4
Amount HMRC have under investigation for tax avoidance by smaller companies and individuals

HMRC's estimate of the tax at risk from avoidance schemes increased between March 2011 and March 2012

	31 March 2011 (£bn)	31 March 2012 (£bn)
Small and Medium Enterprises	1.8	2.9
Individuals and others	7.2	7.3
Total	**9.0**	**10.2**

NOTES
1 Small and Medium Enterprises are defined by HM Revenue & Customs as companies with 500 or fewer employees, that are not part of a complex group.
2 'Others' includes partnerships.
3 The tax at risk is the total amount under investigation at that date, covering all tax years.

Source: HM Revenue & Customs data

HMRC's strategy for tackling avoidance

1.16 In March 2011, HMRC and HM Treasury published a joint strategy for *tackling tax avoidance.*[5] This has three core elements (**Figure 5** overleaf):

- preventing avoidance at the outset where possible;
- detecting avoidance early where it persists; and
- countering avoidance effectively through challenge by HMRC.

Anti-avoidance board and group

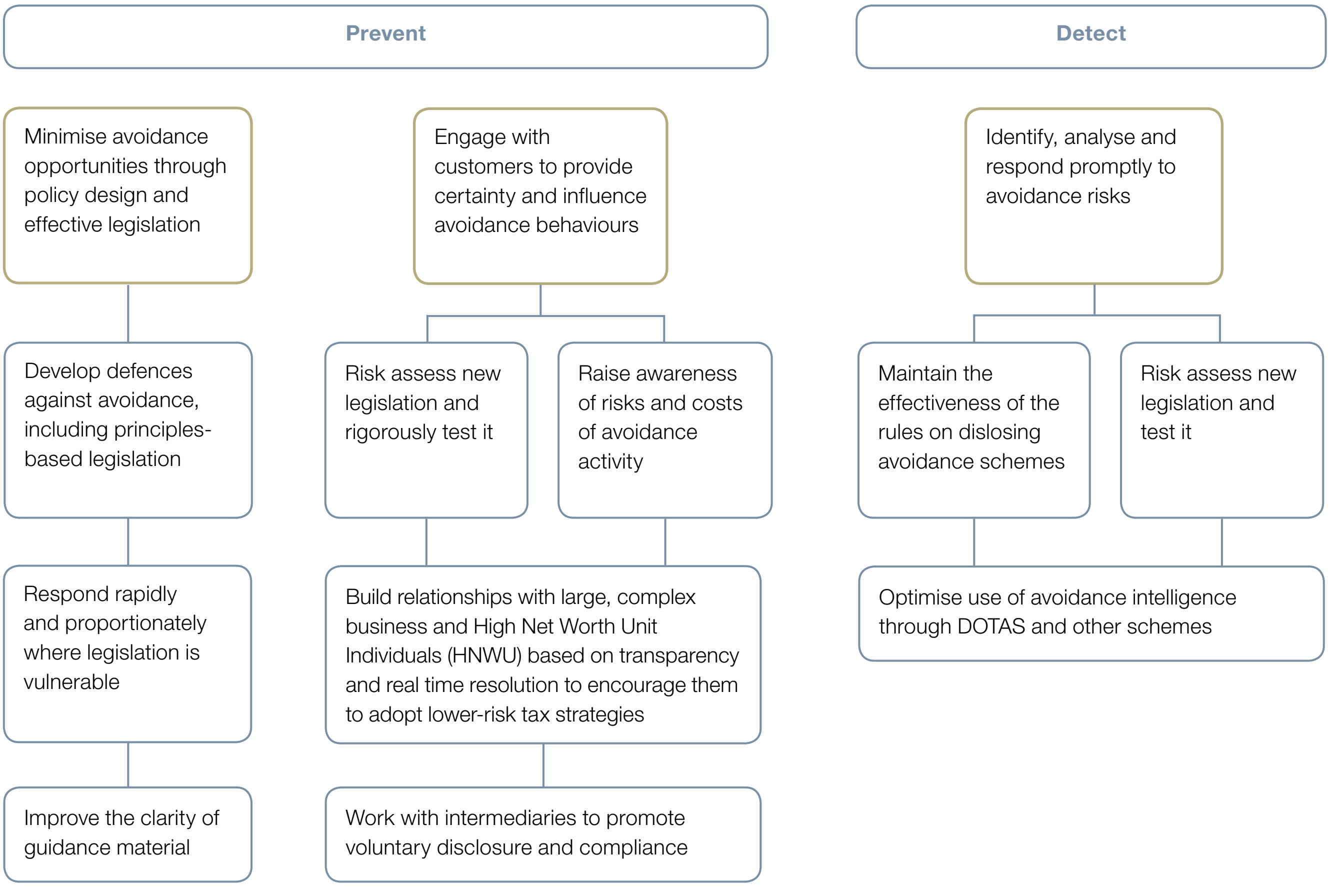
1.17 HMRC has an anti-avoidance board which brings together individuals with skills and experience in tackling avoidance across HMRC. The board sets and monitors HMRC's anti-avoidance strategy, approves strategies for handling avoidance cases and the parameters for settling avoidance issues. It is supported by an anti-avoidance group of 85 people which:

- gives Ministers and others in HMRC specialist advice on avoidance issues;
- tests draft legislation to try to make it avoidance proof;
- maintains an overview of avoidance risk and monitors DOTAS; and
- coordinates and facilitates HMRC's work to counteract avoidance.

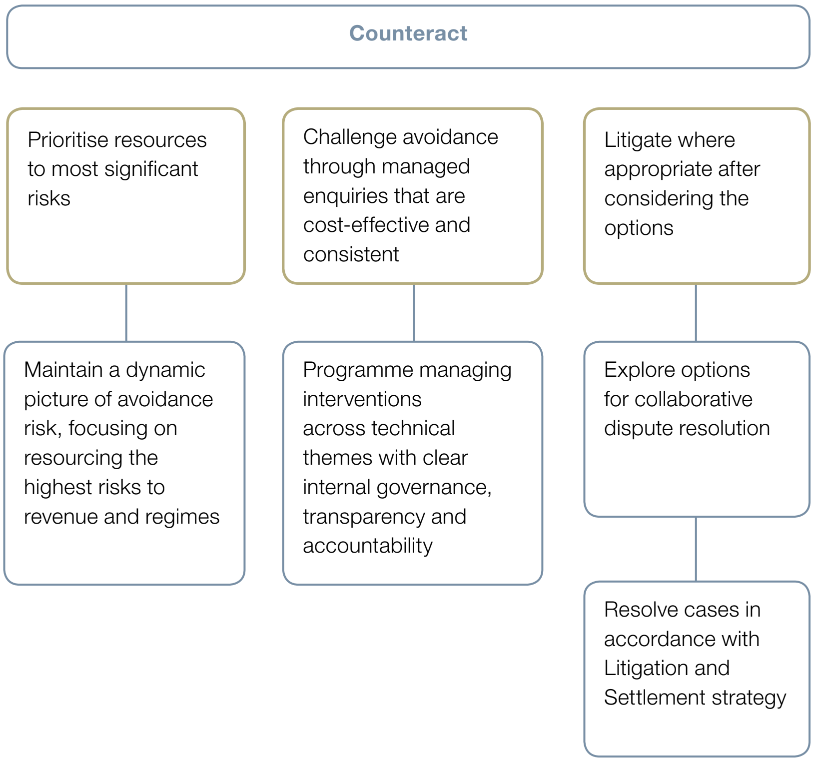
5 HMRC and HM Treasury, *Tackling Tax Avoidance*, March 2011, available at: cdn.hm-treasury.gov.uk/2011budget_taxavoidance.pdf

Figure 5
HMRC's Anti-Avoidance Strategy – *Tackling Tax Avoidance*

HM Revenue & Customs' strategy has three main aims – to prevent, detect and counteract avoidance



Source: HM Revenue & Customs and HM Treasury, Tackling tax avoidance, March 2011


Counteract
Prioritise resources to most significant risks
Challenge avoidance through managed enquiries that are cost-effective and consistent
Litigate where appropriate after considering the options
Maintain a dynamic picture of avoidance risk, focusing on resourcing the highest risks to revenue and regimes
Programme managing interventions across technical themes with clear internal governance, transparency and accountability
Explore options for collaborative dispute resolution
Resolve cases in accordance with Litigation and Settlement strategy

Operational response

1.18 HMRC's operational units are organised by taxpayer group. They investigate and detect avoidance cases alongside their other compliance work. HMRC does not monitor the costs of the resources it commits to tax avoidance as this work is integrated with its wider compliance effort, and the boundaries of avoidance work are hard to define. HMRC's approach is always to make resources available for avoidance work. It does not believe better information on the cost of avoidance work would add value to its business planning.

1.19 HMRC's specialist investigations and local compliance teams investigate most avoidance schemes used by individuals and smaller businesses. In response to our study, HMRC estimated that there were roughly 300 full-time equivalent staff in the teams investigating such schemes, assisted by additional staff across HMRC, including from the anti-avoidance group and Solicitor's Office. In 2011-12, HMRC estimated it achieved additional revenue of £400 million from this work.

1.20 In 2009, HMRC set up the high net worth unit to deal with the tax affairs of the wealthiest individuals. The unit, which has 390 staff, deals with about 5,000 individuals each with assets of over £20 million, allocating a relationship manager to each taxpayer to develop a detailed knowledge of their tax affairs. It assesses the risk for each taxpayer based on their behaviour and uses this assessment to target its work. HMRC estimates that the unit achieved additional revenue from its compliance work of £85 million in 2009-10; £162 million in 2010-11; and £200 million in 2011-12.

1.21 HMRC set up a unit in 2011-12 to extend its coverage of wealthy taxpayers. This unit covers individuals with assets between £2 million and £20 million or who pay tax in the 50 per cent bracket, estimated to be 400,000 people. HMRC aims to have about 320 staff in this unit by April 2013 and forecasts that it will achieve additional revenue of £520 million between 2011 and 2015.

Evaluation of the anti-avoidance strategy

1.22 HMRC has not yet identified how it will evaluate the overall success of its anti-avoidance strategy and the strategy includes no performance measures or indicators. The anti-avoidance board does not have a complete picture of the amount of tax at risk from avoidance; the amount of resources deployed to tackle avoidance; or the trend in the number of open avoidance cases. HMRC is updating its strategy and plans to develop an evaluation methodology.

Proposals to strengthen anti-avoidance legislation

1.23 HMRC is trying to improve the design of legislation so that tax law leaves fewer opportunities for avoidance. The government has decided to introduce a general anti-abuse rule to address the most abusive types of avoidance scheme. The rule follows the independent recommendations of a review led by Graham Aaronson QC, which concluded that a broad and general anti-avoidance rule would not be beneficial to the UK tax system, but that a narrowly defined rule targeted at abusive arrangements would be.[6] HMRC believes that such a rule will provide an effective 'backstop' against the most abusive schemes, though our consultation with wider stakeholders revealed a range of views about what impact it would have. The rule will be included in the 2013 Finance Bill. HMRC is evaluating the impact of the proposed rule on tax revenues, and this will be assured by the Office for Budget Responsibility. HMRC expects this estimate to be published.

6 HM Treasury, *GAAR Study, Report by Graham Aaronson QC*, 11 November 2011.

Part Two

The impact and effectiveness of DOTAS

How the DOTAS regime works

2.1 The government introduced a disclosure regime, the Disclosure of Tax Avoidance Schemes (DOTAS) regime in 2004.[7] DOTAS requires the promoter of certain types of avoidance schemes to disclose information about the scheme to HMRC. Taxpayers who use such a scheme are also required to report the scheme reference number on their tax return. DOTAS is intended to capture information about marketed avoidance schemes, but is not restricted to marketed schemes.

2.2 The policy objectives for DOTAS are:

- "to provide early information about tax avoidance schemes which allows the risk they pose to be assessed, and to inform legislation to close loopholes;
- to identify the users of those schemes to inform compliance work; and
- to reduce the supply of avoidance schemes by altering the economics of avoidance, reducing the returns to promoters and users as schemes are closed down more quickly."[8]

2.3 The DOTAS rules were originally defined narrowly to prevent disclosures that would be of limited value to HMRC but would place a burden on taxpayers and their advisers. DOTAS has since been expanded to include more taxes and more types of scheme. The changes are summarised in **Figure 6**. DOTAS is not intended to capture all areas of avoidance activity, only those where HMRC considers it needs specific information to inform its response.

7 DOTAS excludes VAT. There is a separate disclosure regime for VAT, which was introduced in 2004. This report does not consider VAT avoidance.
8 HMRC, *Lifting the Lid on Tax Avoidance Schemes*, 23 July 2012.

Figure 6
Changes to DOTAS since 2004

The DOTAS rules have been expanded over time

2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012

July 2004

DOTAS launched, covering income tax, capital gains tax and corporation tax but limited in its scope.

HMRC to issue scheme reference numbers to promoters to pass them on to clients.

Penalties for non-compliance of up to £5,000.

August 2005

DOTAS extended to stamp duty land tax, limited to transactions involving commercial property worth more than £5m. Scheme reference numbers not included for stamp duty land tax.

August 2006

Scope of DOTAS specified in July 2004 amended and a series of hallmarks introduced. If a scheme came under one of these hallmarks it now had to be disclosed.

These hallmarks extended DOTAS and allowed it to pick up 'generic' avoidance. The scope was extended based on HMRC's knowledge of the avoidance risks it faced at that time.

May 2007

DOTAS was extended to national insurance contributions through separate legislation mirroring DOTAS.

July 2007

HMRC's information powers extended:

- HMRC can require a promoter to explain why a scheme is not disclosable.
- HMRC can require promoters to provide further information if a disclosure is incomplete.
- HMRC can seek an order from the Tribunal that a scheme is disclosable.
- Enhanced penalties apply if a scheme was not disclosed following a Tax Tribunal order.

November 2008

Changes were made to the scheme reference number system including:

- Co-promoters are no longer exempt from having to pass on scheme reference numbers.
- A promoter must pass on the scheme reference number to the end user of the scheme, even where this includes a chain of intermederies.
- Promoters and others must pass on scheme reference numbers using a specified form, explaining what it is and what it means.

April 2010

Promoters required to disclose client lists of scheme users. Stamp duty land tax rules extended to cover residential property over £1m. The reference number system extended to include stamp duty land tax.

January 2011

A range of changes were made:

- Changing the timing rules to ensure that a scheme is disclosed as soon as it is marketed.
- Introducing powers to require an intermediary, who introduces a client to a scheme, to identify the scheme promoter.
- Higher penalties of up to £1m for non-disclosure.

April 2011

DOTAS extended to Inheritance tax.

Source: HM Revenue & Customs

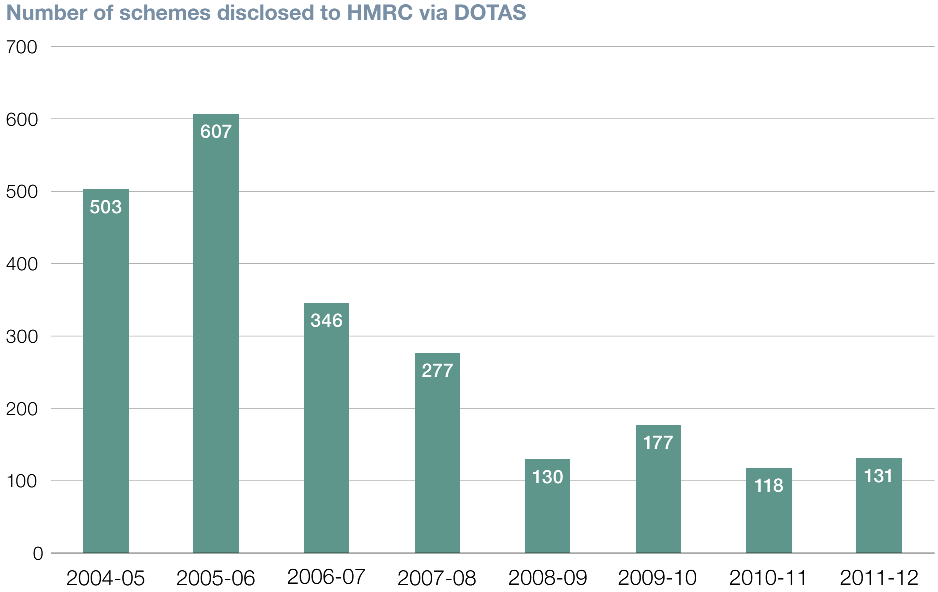
Providing early information to inform changes to tax law

2.4 DOTAS was designed to alert HMRC to avoidance schemes sooner so that it could address them more quickly, restricting the time during which a scheme could be used and preventing other taxpayers from using it. Before DOTAS, HMRC primarily identified the existence of avoidance schemes by analysing taxpayers' returns which did not need to be submitted until several months after the end of the tax year in which the scheme was introduced.

2.5 DOTAS has been effective in providing early warning of large numbers of schemes. A total of 2,289 schemes had been disclosed under DOTAS by the end of 2011-12. After a high number of initial disclosures, the number of schemes disclosed has levelled off at between 118 and 177 a year since 2008-09 (**Figure 7**).

Figure 7
Number of schemes disclosed under DOTAS to HMRC by promoters

After a high number of initial disclosures, promoters have disclosed between 118 and 177 new schemes in each of the last four years



Source: HM Revenue & Customs

2.6 When HMRC receives a disclosure about a scheme that exploits a specific aspect of tax law, it is often able to address it by making a simple change to the legislation. Advised by HMRC, Parliament have initiated 93 changes to tax law to tackle avoidance since the introduction of DOTAS in 2004, though some of these may have been introduced without the early warning that DOTAS provided. **Figure 8** shows an example of prompt action by HMRC to act on information from DOTAS to change legislation.

2.7 Introducing narrowly targeted changes to legislation that stop particular schemes is not always effective and has disadvantages, such as increasing the length and complexity of tax law. They can also open new opportunities for avoidance. While the legislative change may be effective in stopping the particular scheme targeted, variants of the scheme may be introduced which get round the conditions in the new legislation. In some cases, HMRC has therefore evolved its approach towards ‘principle-based’ rather than ‘rule-based’ legislation, so that changes to tax law are broader in scope and typically encompass a range of similar schemes.

Figure 8
‘Sideways loss relief’ case example

DOTAS has enabled HMRC to introduce legislation quickly to stop tax avoidance activity

The scheme

A scheme sought to use a series of transactions in relation to a property business to create an artificial loss that wealthy individuals could set-off against their other income to reduce their tax bill.

Estimated tax at risk

HMRC estimated that tens of millions of pounds of tax was at risk from the scheme being used before HMRC became aware of it, and estimates that further very significant amounts of tax would have been at risk if the law had not been changed.

HMRC’s response

The scheme was disclosed via DOTAS on 5 March 2012. HMRC recognised it as high risk and, aware that it might be used again, advised Ministers to make a ‘fast track’ change to legislation. The change was announced in a ministerial statement on 13 March 2012 and the legislation enacted with retrospective effect to the date of that announcement. HMRC assesses that the legislation has stopped the scheme from being used again, though it is too early to be certain.

HMRC are now challenging the taxpayers that used the scheme before the change in legislation took effect.

Source: HM Revenue & Customs

Identifying the users of schemes

2.8 When a promoter discloses an avoidance scheme, HMRC issues the promoter with a scheme reference number. The scheme user must then record this number on their tax return for each year in which they consider it provides a tax advantage. The objective of this requirement was to help HMRC focus its work on the schemes with the most tax at risk.

2.9 DOTAS has provided information about the use of a large number of schemes. It has shown that some schemes have an effect over several tax years, and may have over a thousand users. The aggregate number of scheme reference numbers reported on tax returns has increased over time (**Figure 9**).

Figure 9

Number of scheme reference numbers reported on tax returns each year

The usage of schemes reported on tax returns has increased to about 10,000 instances in each of the last two years

NOTES

1 The data excludes VAT disclosures.

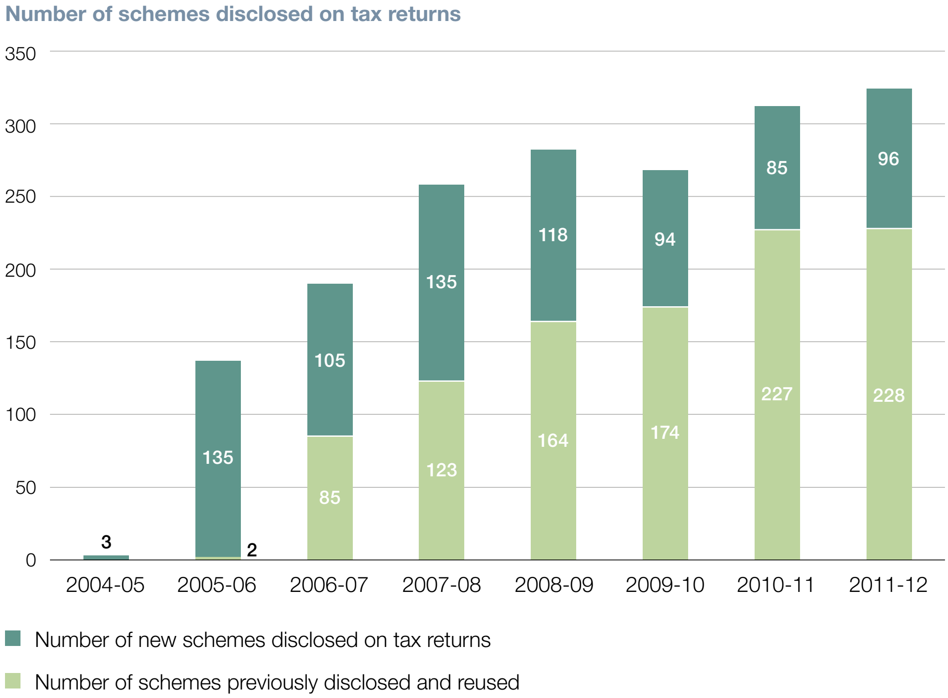
2 The year shows when HMRC received the tax return, not the tax year to which it relates.

Source: HM Revenue & Customs

2.10 The number of different schemes reported on tax returns each year has also increased, rising to 324 in 2011-12 (**Figure 10**). Tax returns also report the use of about 100 new schemes each year, fewer than the number of schemes disclosed by promoters, especially in the early years of DOTAS. Not all schemes disclosed by promoters are actually used, and taxpayers do not always meet their obligation to declare the use of a scheme on their tax return.

Figure 10
Number of different schemes being used each year

The total number of different schemes reported by taxpayers has increased to 324 in 2011



NOTES
1. The data excludes VAT.
2. The year shows when HMRC received the tax return, not the tax year to which it relates.
3. 'Schemes previously disclosed and reused' include schemes where tax benefits are carried forward. These schemes have to be reported each year the benefit is carried forward, even though the scheme will only have been used once.

Source: HM Revenue & Customs

2.11 In a 2009 evaluation of DOTAS, HMRC considered which of its challenges to avoidance schemes would not have happened without DOTAS. It estimated the extent to which DOTAS accelerated its investigations and reduced the resources employed to resolve cases. It found that additional revenue of between £225 million and £650 million a year had been collected against what would have been achieved without disclosures made under DOTAS.

Reducing the supply of avoidance schemes

2.12 HMRC envisaged that DOTAS would eventually reduce the supply of avoidance schemes. If HMRC could close down schemes more quickly, the promoters would not make an economic return from them. Successful operational challenge would also deter scheme users from buying schemes. While the number of schemes disclosed by promoters has decreased since the early years of DOTAS, there remains a steady supply of new schemes disclosed each year.

2.13 It is difficult to isolate the influence of DOTAS on the supply of avoidance schemes from other factors, such as public attitudes to avoidance, changes in corporate governance, and HMRC's enhanced engagement with large businesses. The overall amount of avoidance is also affected by a range of economic factors, including tax rates and tax allowances.

2.14 In its 2009 evaluation of DOTAS, HMRC cited several sources of evidence that the market of promoters had changed significantly since the introduction of DOTAS. We interviewed a number of tax practitioners and expert commentators, including accountancy and law firms and professional representative bodies, who consistently reported that the market had changed and, to some extent, polarised. Our interviewees considered that an increasing proportion of marketed schemes were now sold by small specialist firms, often known as 'tax boutiques'. Our analysis of the DOTAS disclosures made by promoters since 2004 supports this view.

2.15 HMRC describes the current market of promoters as a spectrum, from promoters who are generally compliant and willing to engage, to those who stretch the rules to the limit and will typically exist only to invent and administer avoidance schemes. The latter group represents a significant risk to HMRC's efforts to combat tax avoidance.

2.16 HMRC has not directly been able to prohibit promoters marketing schemes as it lacks the legal powers to do so. Instead, it has directed its resources at challenging the users of schemes and their agents.

2.17 HMRC has begun a programme of work to strengthen its existing engagement with promoters. Not all promoters are willing to engage with HMRC, but it has held meetings with some to discuss the schemes they promote and the promoter's interpretation of the disclosure rules. HMRC hopes this approach will build its intelligence on avoidance schemes, help it consider which promoters it could engage directly and assess how it might seek to deter the most aggressive types of avoidance activity. It is also considering the potential impact of investigating the personal and company tax returns of promoters, and whether it could use consumer law, such as mis-selling provisions, to deter promoters from marketing the most abusive schemes.

Enforcing the DOTAS rules

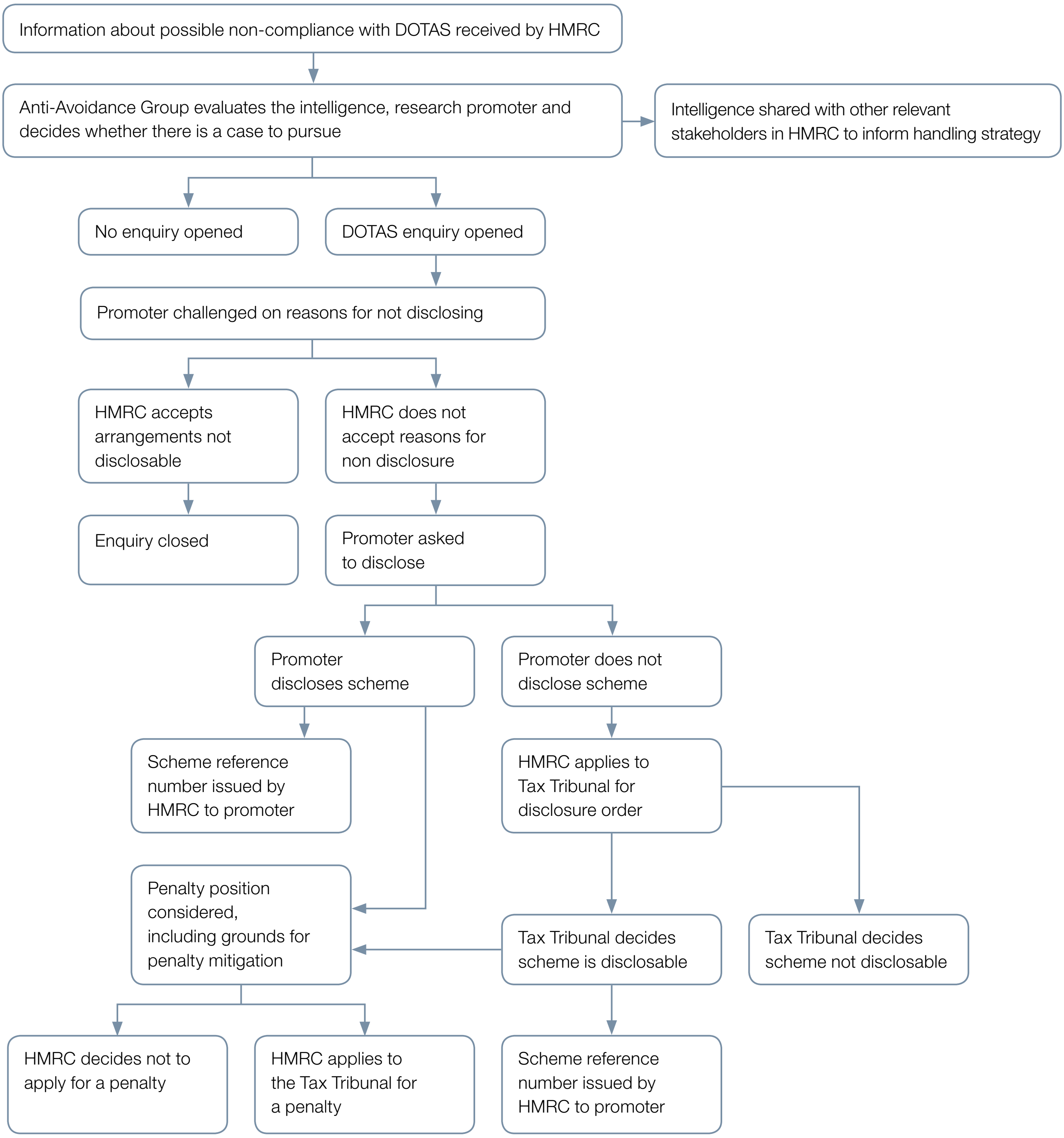
2.18 DOTAS can only fully achieve its objectives if promoters and users comply with their obligations. HMRC does not have data to estimate the number of schemes that should have been disclosed under DOTAS but were not. As part of its work to identify the tax gap for 2010-11, HMRC surveyed its project managers to estimate the proportion of tax at risk identified through DOTAS. It estimated by this method that DOTAS captured 46 per cent of the tax at risk from avoidance. HMRC recognises that of the remainder, a large proportion would fall outside the scope of DOTAS, but has not sought to identify separately the level of non-compliance with the DOTAS rules. However, it does not believe that a significant amount of avoidance that should have been disclosed has not been.

2.19 HMRC believes that its approach of assigning a relationship manager to the largest businesses, and now also to the wealthiest individuals, significantly reduces the risk that avoidance is undetected. The relationship managers work closely with the businesses and individuals to develop an in-depth understanding of their tax affairs, which informs their assessment of risk. These taxpayers also frequently engage in early discussion of issues with their relationship manager, so HMRC is well placed to get timely information should the taxpayer be considering the use of an avoidance scheme.

2.20 Another significant source of information on potential avoidance is HMRC's own risk assessment of tax returns. HMRC requires its staff to report suspected non-compliance with DOTAS to the anti-avoidance group's intelligence team. The intelligence team evaluates this information and decides what action to take (**Figure 11** overleaf). It also does its own research using data mining and receives information about schemes from external sources, including competing promoters or taxpayers seeking advice about schemes they might use.

Figure 11
HMRC's processes for dealing with potential non-compliance with the disclosure regime

HMRC can apply to the Tax Tribunal for penalties on those who don't comply with the DOTAS disclosure requirements



Source: HM Revenue & Customs

2.21 Since September 2007, HMRC has opened 365 cases into the potential failure of a promoter to comply with DOTAS. HMRC can apply to the Tax Tribunal to issue penalties for non-disclosure, both for promoters who fail to disclose schemes under DOTAS and for taxpayers who do not report having used a registered scheme. HMRC has applied to the Tax Tribunal for penalties for non-disclosure by promoters 11 times since DOTAS began in 2004, each time securing the maximum £5,000 penalty. It has not applied for any penalties in relation to taxpayers for failing to report the use of a registered scheme (**Figure 12**). The legislation requiring users to disclose a scheme reference number (SRN) on their tax return originally allowed users to correct their tax return to put in the missing reference number if failure to report the SRN had been identified by HMRC. In April 2009, Parliament amended this legislation to allow HMRC to apply for penalties in these circumstances. Since then, it has opened 45 enquiries into taxpayers for failing to record a scheme reference number on their tax return.

Figure 12

HMRC's powers to apply penalties for non-disclosure and the penalties issued

HMRC has applied 11 penalties for non-disclosure under DOTAS since July 2004

Legislation	Summary of powers	Number and value of penalties issued
Finance Act 2004	Special commissioners (subsequently Tax Tribunal) can issue penalty of up to £5,000 for failure to disclose a scheme.	Eleven penalties of £5,000 Three in 2007-08 Three in 2008-09 Three in 2010-11 Two in 2011-12
Finance Act 2004	HMRC can apply a penalty for not disclosing a scheme reference number, ranging from £100 per scheme for the first offence to £1,000 per scheme for the third offence in 36 months.	None
Finance Act 2010	Penalty for failure to disclose a scheme raised to a maximum of £1 million.	None

Source: HM Revenue & Customs

2.22 HMRC faces a challenge in seeking to impose enough penalties to deter non-compliance by those promoters who perceive an advantage in not disclosing their schemes. Even when HMRC can demonstrate that a scheme should have been disclosed by a promoter, the promoter will normally have obtained a legal opinion that the scheme did not meet the criteria for disclosure. The promoter will rely on this as providing a 'reasonable excuse' for non-disclosure, in which case non-compliance cannot be demonstrated.

2.23 HMRC recognises that the difficulty in applying penalties has reduced their intended deterrent effect and is consulting on raising the hurdle for reasonable excuse, and on imposing additional reporting requirements on those who fail to disclose.[9]

2.24 HMRC's 2009 evaluation of DOTAS found that in 2007 up to 40 per cent of scheme users did not report the scheme reference number. In 2008, HMRC strengthened the DOTAS regime to address this issue, and in January 2011 it introduced a requirement for promoters to disclose a list of their clients from 1 April 2011.

9 HMRC, *Lifting the Lid on Tax Avoidance Schemes*, 23 July 2012.

Part Three

HMRC's response to marketed avoidance schemes

3.1 This part describes how HMRC investigates cases of suspected avoidance schemes marketed to businesses and individuals. It illustrates the complexity of gathering the information HMRC requires to challenge schemes and the actions HMRC is taking to increase its effectiveness.

The caseload of open avoidance cases

3.2 At 31 August 2012, HMRC was investigating 41,000 avoidance cases in respect of smaller companies and individuals, the vast majority of which resulted from the use of marketed schemes. HMRC does not collate data to show how the volume of open cases has changed over time, or how many cases it has been successful in defeating. The number and age profile of open cases is monitored at a directorate level, but is not collated centrally. This means that the anti-avoidance board does not know whether, in aggregate, the number of open cases is increasing or reducing or whether the stock of open cases is manageable.

3.3 In 2011, HMRC introduced a new process, known as Managing Avoidance Risk, to improve and standardise its management information and governance, and reduce the decision-making time on avoidance cases. Managing Avoidance Risk is being rolled out across all cases and should be fully implemented by 31 March 2013.

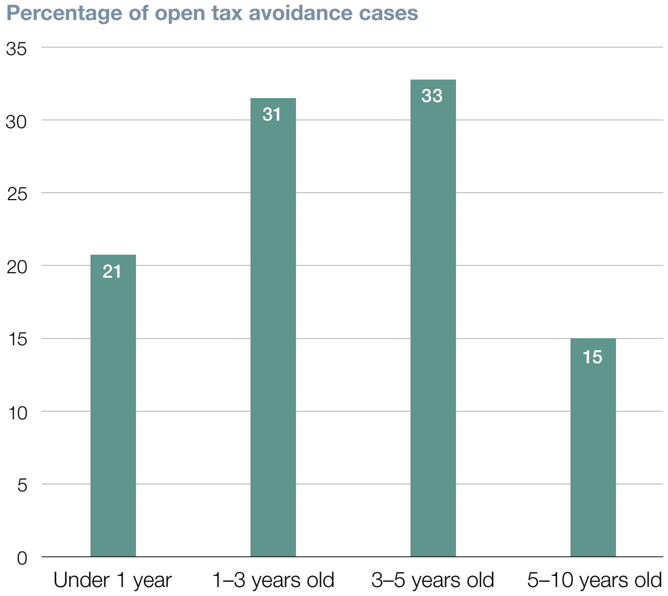
Timescales for resolving avoidance cases

3.4 **Figure 13** overleaf shows that the majority of avoidance cases that were open in August 2012 had been open between one and five years.

3.5 There can be very long timescales involved in investigating, litigating and resolving avoidance cases, with the oldest open cases dating back to the early 1990s. The fee paid to scheme promoters will often include a contribution to a fund to defend the scheme in litigation.

Figure 13
Age profile of avoidance cases that were open in August 2012

Most open tax avoidance cases are between one and five years old



NOTES
1 This data is based on individuals and small and medium enterprises, excluding large businesses.
2 This data is based on analysis of 35,000 open cases, not the 41,000 open cases.

Source: HM Revenue & Customs

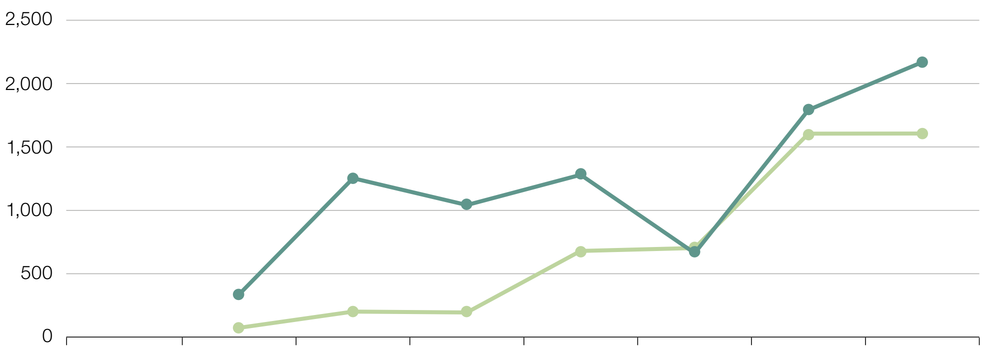
3.6 The long timescale for resolving cases increases the economic advantage to taxpayers of using an avoidance scheme because, however the case is resolved, taxpayers receive the cash-flow advantage of not paying tax while the investigation is under way. If the case is settled in HMRC's favour, then interest is charged from the date the tax was due. The main economic factors that might deter a taxpayer from buying avoidance schemes are the fees charged by the scheme's promoter, the financial uncertainty should the scheme be challenged by HMRC, and the burden on the taxpayer of an HMRC investigation, with the potential for litigation which is held in public.

3.7 Even knowing that HMRC is investigating a type of avoidance scheme may not deter other taxpayers from buying similar schemes. **Figure 14** shows that the number of taxpayers who disclosed the use of partnership loss and employee benefit trust schemes increased between 2005 and 2011, despite HMRC having had a range of investigations under way to counteract such schemes.

Figure 14

The number of taxpayers disclosing the use of employee benefit trusts and partnership loss avoidance schemes

The number of taxpayers disclosing the use of employee benefit trusts and partnership loss schemes has increased, even though HMRC has been challenging such schemes for some time



	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Partnership Loss schemes		337	1,253	1,042	1,280	662	1,792	2,169
Employee Benefit Trust schemes		73	201	194	680	703	1,605	1,606

NOTE

1 The year shows when HMRC received the tax return, not the year to which it relates.

Source: HM Revenue & Customs DOTAS disclosure data

How HMRC gathers information and challenges suspected avoidance cases

3.8 All schemes disclosed or identified are considered by the anti-avoidance board, which approves the proposed response to the scheme. This could be to:

- accept that a type of scheme works and monitor its use; or
- challenge the schemes in use, if necessary through litigation; and/or, if appropriate,
- advise Ministers to legislate to stop further use of schemes of that type.

Where it is agreed to challenge the scheme, HMRC project manages all the cases using that scheme to ensure it treats them consistently.

3.9 HMRC has recognised the need to improve the way it manages avoidance cases. In June 2011, it introduced an avoidance acceleration project, aiming to improve project management, resolve cases more quickly, and reduce the number of unresolved cases. The Managing Avoidance Risk process is also intended to help HMRC in reaching a decision on how to address each new scheme within months of having first identified it.

3.10 HMRC's response to three of the largest types of marketed avoidance scheme is shown in **Figure 15**.

Figure 15
HMRC's response to avoidance schemes

HMRC can take many years to investigate avoidance schemes

Partnership Loss schemes

£3,500 million, 14,000 users

Legislative action

A considerable amount of legislation has been introduced over the last ten years to counter partnership loss schemes. Initially, the legislation tackled a specific type of scheme that used film tax relief. Later legislation has been aimed more widely at restricting relief in cases where the person claiming it is not active in the trade it relates to.

Investigation and Litigation

HMRC is investigating individuals and partnerships involved in these schemes.

HMRC has won three important cases in litigation: *Tower MCashback LLP 1 & Anor v. HMRC*; *Icebreaker 1 LLP v. HMRC*; *Samarkand Film Partnership No 3 & Ors v. HMRC*. HMRC is awaiting decisions in a further two cases, and more Tax Tribunal hearings are scheduled.

Example of the lifecycle of a scheme

In 2005, HMRC received an anonymous tip-off about a partnership loss scheme, one of seven run by the same promoter. It had already opened enquiries into three of these schemes.

In June 2006, HMRC made one of these schemes the 'lead' case, directing most of its effort to investigating this case, with the other schemes treated as 'followers'.

After several years of fact gathering and three meetings with legal counsel, HMRC decided that the risks required a project covering all of the promoters activities, which began in June 2011. In January 2012, the promoter rejected HMRC's proposed settlement terms and HMRC is preparing for litigation.

Employee Benefit Trust schemes

£1,700 million, 3,400 users

Legislative action

Legislation was introduced in the Finance Act 2003 with the aim of preventing the abusive use of trusts. The 'disguised remuneration' legislation was introduced in the Finance Act 2011 with the aim of tackling avoidance arrangements that pay employees through third parties.

Investigation and Litigation

HMRC is investigating schemes and has launched the 'Employee Benefit Trust settlement opportunity' to encourage users to pay the tax avoided, rather than face litigation.

HMRC has won several cases in litigation and is currently litigating 43 cases.

Example of the lifecycle of a scheme

In July 2007, an employee benefit trust scheme was disclosed to HMRC under DOTAS.

In September 2008, HMRC decided to investigate by opening enquiries into users' 2007-08 tax returns.

In February 2011, HMRC began to prepare to litigate a lead case. In May 2012, HMRC decided to prepare to litigate two further cases to provide stronger evidence to other users that the scheme would not succeed. HMRC expects the cases to go to the First-tier Tribunal in 2013.

Figure 15 *continued*
HMRC's response to avoidance schemes

HMRC can take many years to investigate avoidance schemes

Employment intermediary schemes

£600 million, 16,000 users

Legislative action

Managed Service Companies legislation was introduced in April 2007. The disguised remuneration legislation introduced in the Finance Act 2011 also targeted these arrangements.

Investigation and Litigation

HMRC is currently investigating the schemes.

One case was heard at Tax Tribunal in May 2012 and is awaiting decision. Two further cases are awaiting decision.

Example of the lifecycle of a scheme

In April 2009, a scheme involving service companies was disclosed to HMRC under DOTAS. The scheme ran in the 2009-10 and 2010-11 tax years, and involved over 1,400 users.

In 2010, HMRC began investigating a sample of cases to inform its approach to all outstanding cases.

HMRC is devising a settlement strategy to ask the scheme's users to pay the amount of tax due, but is prepared to litigate if necessary.

Source: HM Revenue & Customs data

3.11 HMRC can take several years to gather all relevant information about a scheme. HMRC has powers to require a taxpayer to provide information about tax planning or avoidance schemes before it receives the users' tax returns. HMRC needs sufficient evidence to enable it to use these powers. Information notices need to be clear, specific, relevant and non-speculative. HMRC therefore frequently has to either wait for further detailed information or until returns are filed before it can open enquiries. HMRC sometimes informally asks scheme users and intermediaries how a scheme works, but there is no obligation for users or intermediaries to provide any information until it is formally requested. **Figure 16** overleaf shows how HMRC investigated a scheme disclosed via DOTAS involving an employment intermediary.

Figure 16
Employment intermediary case example

It can take some time before HMRC obtains detailed information about how a scheme works

The scheme

The scheme is used mainly by individuals working as contractors (the ‘scheme users’) and earning at least £50,000 a year.

The scheme users became employees of an offshore employer for the 2011-12 tax year. The offshore employer seconded employees to a UK intermediary, which invoiced the companies using the scheme users’ services.

The offshore employer paid the scheme users the minimum wage. The scheme users would have been liable to pay the small amount of income tax and national insurance contributions due on this. The offshore employer loaned the scheme users the rest of the money they had earned as interest-free loans. Interest-free loans are a benefit in kind, and generate only a small tax charge. Thus, the scheme users received their full income, less any administration costs, but will have paid tax only on an amount equal to the minimum wage plus a small charge for the benefit in kind.

HM Revenue & Customs response

The scheme was notified to HMRC via DOTAS in July 2011. In August 2011, HMRC began investigating the scheme and issued a warning about this type of scheme on its website. The promoter met HMRC and explained how the scheme operated. HMRC also invited some of the scheme users to meet so that it could gather information about how the scheme worked and target its formal requests for information. HMRC could not oblige people to attend these meetings and none chose to do so.

HMRC knows that this scheme had approximately 1,500 users because the offshore employer would have had to submit a year end return listing its employees. HMRC received this information in May 2012. As HMRC has received scheme users’ tax returns, it has begun to open enquiries. It is investigating how much was received as loans, and whether these will in practice be repaid.

Source: HM Revenue & Customs

Using litigation to counteract avoidance schemes

3.12 HMRC has a high success rate when it litigates avoidance cases. **Figure 17** shows that HMRC has taken 110 cases to litigation since April 2010. Of the 60 cases where there have been judgments, HMRC was successful in 51.

3.13 Compared to the number of users of avoidance schemes, only a small number of cases enter litigation. Part of the explanation is that one case, or a small group of cases, will be litigated as a lead case, with the judgment intended to resolve a group of similar cases. The approach of using lead cases does not always succeed, however, because taxpayers may not be prepared to settle their case on the basis of rulings on similar cases. Where it considers it feasible, HMRC may ask the Tax Tribunal to apply a ruling (Rule 18) to bind a group of follower cases to accept the judgment of a lead case, subject to any subsequent appeal to distinguish the related cases.

Figure 17
Outcome of avoidance litigation cases

When HM Revenue & Customs litigates it has a high success rate

	2010-11	2011-12	April 2012 to October 2012	Total 2010 to October 2012
Number of cases entering litigation	39	55	16	**110**
Number of cases ongoing	5	33	12	**50**
Number of cases with judgments	34	22	4	**60**
Number of cases where HMRC were successful	29	19	3	**51**
Percentage where HMRC were successful	85%	86%	75%	**85%**

Source: HM Revenue & Customs

Enhancing communication to discourage the use of avoidance schemes

3.14 HMRC recognises the need to understand and influence the behaviour of scheme users to try to deter the uptake of aggressive avoidance schemes. It communicates with taxpayers and their agents about avoidance by publishing on its website 'Spotlights', short case examples of avoidance arrangements or schemes that HMRC are likely to challenge.

3.15 HMRC has recognised the potential to do more to influence the behaviour of potential avoiders and has established a pilot project which is evaluating the use of behaviour change techniques to effectively 'nudge' taxpayer behaviour. For example, it has analysed the users of a high volume scheme according to their track record of avoidance behaviour, identifying whether they are:

- first-time users of an avoidance scheme;
- infrequent users of avoidance schemes;
- frequent users of avoidance schemes; or
- 'serial avoiders'.

3.16 It plans to send letters with the message judged most likely to encourage that user to withdraw from the scheme. HMRC intends to pilot this approach and evaluate the results before deciding what further potential it has to deploy similar techniques.

3.17 In September 2012, HMRC introduced an anti-avoidance communications plan to capitalise on public interest in avoidance. HMRC recognised the need for a specific, dedicated anti-avoidance communication plan to keep stakeholders informed of its anti-avoidance activity and influence behaviour. HMRC also consults professional and representative bodies to identify how it might deter avoidance.

Appendix One

Our audit approach

1 This study examined HMRC's strategy for tackling tax avoidance schemes, including the effectiveness of its disclosure regime (DOTAS) and its response to tax avoidance schemes when it detects them. It responds to parliamentary and public interest in schemes used by individuals to significantly reduce their tax bill.

We assessed the extent to which HMRC:

- has an effective strategy in place to tackle the risk of avoidance;
- is using its DOTAS regime effectively to detect and help prevent marketed tax avoidance schemes; and
- is effective in responding operationally to avoidance schemes where it detects them.

2 Our audit approach is summarised in **Figure 18** overleaf. Our evidence base is described in Appendix Two.

Figure 18
Our audit approach

The objective of government

HMRC has an objective in its business plan to **safeguard the flow of money to the Exchequer, to ensure money is available to fund the UK's public services, through collection, compliance and enforcement activities**.

How this will be achieved

Tax avoidance represents a significant part of the UK tax gap. HMRC's new anti-avoidance strategy focuses on three core elements:

- preventing avoidance at the outset where possible;
- detecting it early where it persists; and
- countering it effectively through challenge by HMRC.

Our study

Our study examined HMRC's strategy for tackling tax avoidance schemes, including the effectiveness of its disclosure regime (DOTAS) and its response to tax avoidance schemes where it detects them.

Our evaluative criteria

HMRC has a strategy in place to tackle tax avoidance which it updates on the basis of emerging risks, and has a means of measuring its effectiveness.

The disclosure regime is effective in helping HMRC to prevent, detect and counteract avoidance.

HMRC responds promptly and effectively to tax avoidance schemes where it detects them.

Our evidence

(see Appendix Two for details)

We assessed this by:

- Reviewing HMRC's **published documents and internal management information**.
- **Reviewing and mapping processes** for discovering emerging avoidance risks, formulating handling strategies, and monitoring the effectiveness of anti-avoidance work.
- **Interviewing** relevant staff within HMRC's anti-avoidance group and across the operational arms of its business.

We assessed this by:

- **Interviewing wider stakeholders** to establish different perspectives on what impact DOTAS has had.
- **Reviewing how HMRC has changed tax law** to prevent avoidance.
- Commissioning an **academic review of DOTAS** and the tax avoidance landscape.
- **Analysing data** on the disclosure of avoidance schemes by promoters and on the use of such schemes by taxpayers.
- **Reviewing management information** on how HMRC seeks to enforce DOTAS and apply penalties for non-disclosure.

We assessed this by:

- **Analysing management information** on open avoidance cases, the tax at risk, and the revenue achieved through avoidance work.
- **Examining case examples** of HMRC's response to marketed avoidance schemes.
- Commissioning a **review of anti-avoidance measures in other countries.**

Our conclusions

HMRC does not monitor the costs of its anti-avoidance work and has not yet identified how it will evaluate its overall anti-avoidance strategy. This reduces its ability to make informed decisions about where it should direct more effort, and how to best reduce the 41,000 open avoidance cases. HMRC cannot therefore demonstrate that its strategy to tackle marketed tax avoidance schemes provides value for money.

Appendix Two

Our evidence base

1 Our independent conclusions on the effectiveness of HMRC's measures to prevent, detect and counteract marketed tax avoidance schemes were reached following our analysis of evidence collected between August and October 2012. Our audit approach is outlined in Appendix One.

2 **We assessed whether HMRC has a strategy in place to tackle tax avoidance which it updates on the basis of emerging risks, and has a means of measuring its effectiveness**.

- We carried out a **review of published documents**, including HMRC's anti-avoidance strategy and business plan, **and of unpublished management information**.
- We **reviewed and mapped the processes** for discovering emerging risks, and for monitoring the effectiveness of anti-avoidance work. This included looking at HMRC's risk identification and DOTAS processes.
- We **interviewed** relevant staff within HMRC's anti-avoidance group and across the operational arms of its business. We also observed two meetings of HMRC's anti-avoidance board.

3 **We assessed the impact and effectiveness of the DOTAS regime in helping HMRC to prevent, detect and counteract avoidance**.

- We **interviewed HMRC staff** involved in developing DOTAS and keeping track of DOTAS disclosures to establish how the regime had evolved since 2004 and how its impact is monitored.
- We carried out **external consultation** with a range of groups with relevant experience, including tax advisers, accountancy firms, lawyers, academics and professional bodies to obtain a broad understanding of the different perspectives on DOTAS.
- We **analysed DOTAS disclosure data** to look at patterns of avoidance behaviour and identify the factors that might affect the volume of disclosures.
- We **collected data** on the penalties HMRC has applied on DOTAS and the number of investigations into non-compliance. We also interviewed HMRC staff to establish how they detect avoidance activity that is not disclosed under DOTAS.

- We **reviewed how HMRC has changed tax law** to prevent avoidance by interviewing those responsible for designing changes and drafting new legislation. We examined specific case examples where HMRC had introduced new legislation in response to an avoidance threat. We reviewed HMRC data on the amount of tax at risk which it hoped to protect by introducing legislative change.

- We commissioned an **academic review of DOTAS and the tax avoidance landscape** to obtain an independent assessment of the impact and effectiveness of the regime as it has been implemented by HMRC.

4 We assessed whether HMRC responds promptly and effectively to tax avoidance schemes where it detects them.

- We **analysed management information** on open cases, the tax at risk and the revenue achieved through avoidance work by collating the data held across HMRC's operational divisions.

- We **reviewed case examples** of how HMRC investigated specific avoidance cases to evaluate HMRC's management of their avoidance work and the challenges they face.

- We commissioned a **review of anti-avoidance measures in eight countries** to identify the different mechanisms by which tax authorities seek to prevent and detect tax avoidance schemes.

Appendix Three

International comparators

1 We looked at the approach to tackling mass marketed avoidance schemes in eight other countries. Differences in the legislative frameworks, tax regimes, culture and size of the economies mean that none of the countries is directly comparable with the UK, but we identified and compared key features of the anti-avoidance measures (**Figure 19** overleaf).

2 All but one of the eight countries either had a General Anti-Avoidance Rule, or a similar provision that could be applied to tax cases. The use of such rules varied considerably, but revenue authorities were normally successful in applying them to the most blatant forms of avoidance scheme. In New Zealand, the revenue authority has won a large number of well-publicised cases. Like the UK, most countries also had targeted anti-avoidance legislation to tackle specific types of avoidance.

3 All eight countries used some form of advance rulings, whereby a taxpayer can apply to the tax office to get a judgement on whether a tax arrangement is acceptable before using it. In some countries, including the UK, these were limited to certain narrowly defined transactions. In Denmark, there was evidence that applications for rulings had led the revenue authority to change legislation even before responding to the taxpayer.

4 The United States had a disclosure regime before the UK, and Ireland introduced its regime to follow the UK's model. The countries with disclosure regimes all applied penalties to promoters for not complying. Australia and New Zealand also had penalties they could apply to promoters who market both tax avoidance and tax evasion. In New Zealand, the incidence of marketed avoidance schemes is low, which may indicate that the existence of such penalties has had a deterrent effect.

Figure 19
Key anti-avoidance measures in other countries

Country[1]	General Anti-Avoidance Rule?[2]	Advance Rulings?[3]	Disclosure regime?[4]	Promoter penalties?[5]
Australia	Yes	Yes	No	Yes, for promoting tax avoidance schemes.
Canada	Yes	Yes	Yes	Yes, for non-compliance with disclosure regime.
Denmark	No	Yes	No	No
Ireland	Yes	Yes	Yes	Yes, for non-compliance with disclosure regime.
Netherlands	No, but general abuse of law rule applies to tax cases.	Yes	No	No
New Zealand	Yes	Yes	No	Yes, for promoting tax avoidance schemes.
Sweden	Yes	Yes	No	No
US	No, but economic substance.	Yes	Yes	Yes, for non-compliance with disclosure regime.
UK	Proposed in 2013.	Yes	Yes	Yes, for non-compliance with disclosure regime.

NOTES

1 We selected the countries where the concept of marketed avoidance schemes existed, such that a meaningful comparison of the measures to tackle marketed schemes could be made.

2 Does the country have a general anti-avoidance rule, or similar general legislative provision for tackling avoidance?

3 Does the Revenue Authority issue rulings that provide certainty on the tax treatment of specific transactions or arrangements?

4 Does the country have a tax avoidance disclosure regime (such as DOTAS in the UK)?

5 Does the country have provisions for applying penalties to the promoters of avoidance schemes?

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