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HM Revenue & Customs

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# Tax avoidance: tackling marketed avoidance schemes

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# 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.