



National Audit Office

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## **Report**

by the Comptroller  
and Auditor General

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## **HM Revenue & Customs**

Tackling tax fraud:  
how HMRC responds to  
tax evasion, the hidden  
economy and criminal attacks

# Key information

## Figure 1

What this report is about

**This report looks at tax fraud.** This is where the law has been broken.

This differs from our previous work on tax avoidance, which looked at the problem of people bending the rules of the tax system to gain a tax advantage that Parliament never intended.

### Definitions of tax fraud

HM Revenue & Customs (HMRC) has identified three types of behaviour that illegally deprive the Exchequer of tax revenue; we refer to these as tax fraud.

#### Evasion

when registered individuals or businesses deliberately omit, conceal or misrepresent information to reduce their tax liabilities. Evaders will typically engage with HMRC, but understate a declared source of income

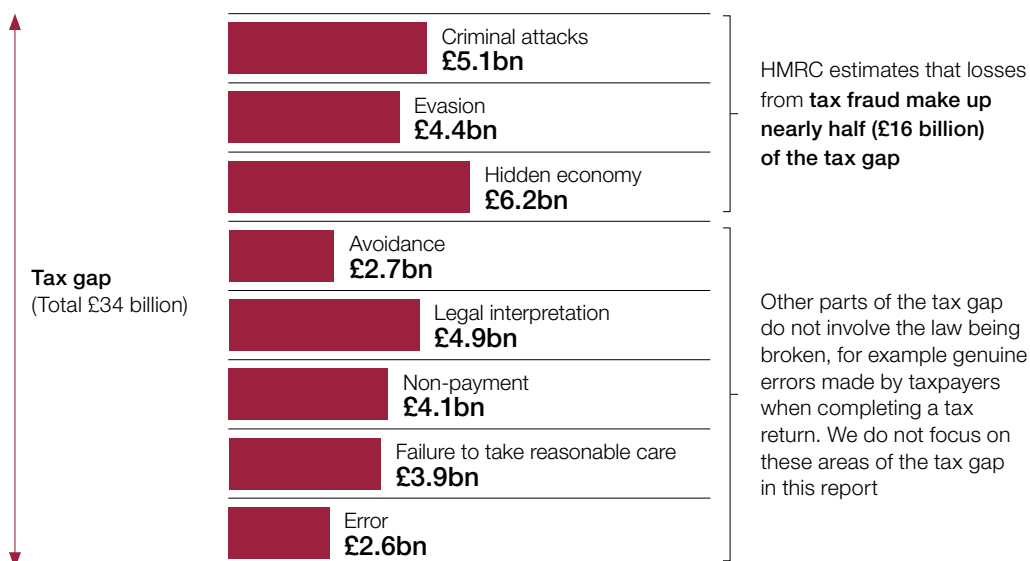
#### Hidden economy

involves people whose entire income is unknown to HMRC ('ghosts') and those for whom HMRC knows of some sources of income but not others ('moonlighters')

#### Criminal attacks

typically involve coordinated and systematic actions by criminal gangs, with varying levels of sophistication and organisation

### Losses from tax fraud are £16 billion per year



Source: National Audit Office

**HMRC addresses tax fraud as part of its overall approach to tackling non-compliance.** Non-compliance encompasses all of the tax gap.

**HMRC's overall approach to tackling non-compliance is threefold:**

- **Promote** compliance with tax law.
- **Prevent** people and businesses getting their tax affairs wrong.
- **Respond** when people and businesses do get it wrong.

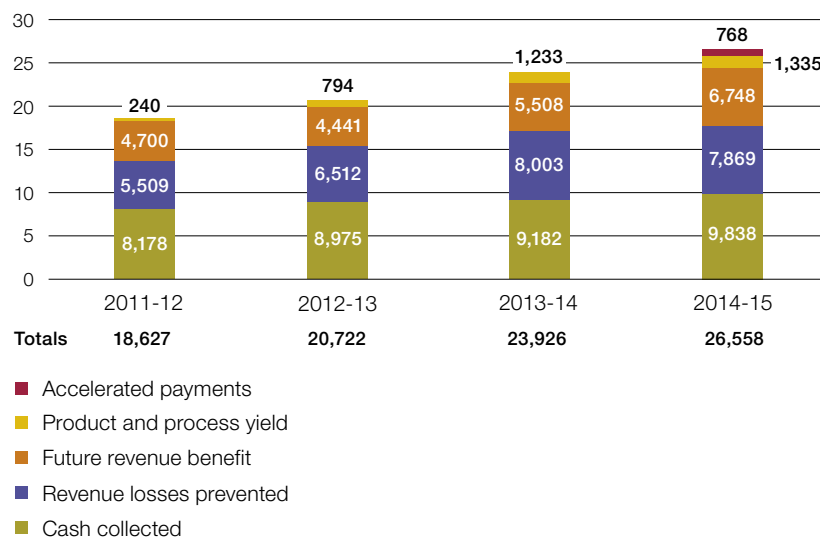
HMRC's Enforcement and Compliance division is responsible for identifying and managing risk to taxation.

**'Compliance yield' is the additional tax revenue generated by HMRC's work to close the tax gap**

HMRC has met its overall targets to increase compliance yield. It reported additional revenue of £26.6 billion in 2014-15, exceeding its target by £0.6 billion.

It has only partial data on how much revenue was protected by its work to tackle tax fraud.

**Yield from tackling all parts of the tax gap (£m)**



# Summary

## What we mean by tax fraud

**1** HM Revenue & Customs (HMRC) is responsible for administering the tax system, including the management and reduction of risks to tax revenue. HMRC measures the gap between what tax revenue it should in theory collect and what it does collect (the tax gap) and assesses what behaviour led to that gap. Where these behaviours lead to the law being broken we refer to this as ‘tax fraud’ (**Figure 1** on pages 4 and 5).

**2** Tax fraud is a longstanding and intractable problem, not only for HMRC but for tax administrations across the world. Reducing the amount of tax that is lost because of people and businesses acting illegally is a high priority for HMRC.

**3** HMRC addresses tax fraud as part of its overall response to those who fail to comply with their tax liabilities. HMRC’s wider compliance and enforcement work encompasses all the behaviours that contribute to the tax gap. The difference between behaviours is not always clear cut. Tax fraud differs from tax avoidance, which involves acting within the letter but not the spirit of the law; when investigated, tax avoiders may be found to have misused tax rules but their actions are not normally illegal.

## Context of this report

**4** This report provides an overview of the issues facing HMRC in dealing with tax fraud and how it has responded to them. Over the course of this Parliament we will evaluate how effective HMRC is in tackling different facets of tax fraud. In this report we describe:

- the nature and scale of tax fraud in the UK (Part One);
- how HMRC tackles these problems (Part Two); and
- HMRC’s approach to prosecutions (Part Three), which has been a particular area of interest to the Committee of Public Accounts.

**5** We also reflect on the choices to be made in designing an approach to tackle tax fraud and the importance of data and analysis to inform and influence these choices. The way that HMRC addresses tax fraud is taking place in the context of wider changes it is making to its business. In particular, these changes have focused on transforming the business processes and systems that collect tax from those who are willing to pay, which accounts for 95% of all tax revenue. Since 2010, HMRC has also made a successful case for investment in its enforcement and compliance work in order to increase the revenue it raises from those less willing to comply, which accounts for the remaining 5% of revenue.

**6** HMRC has an ambitious long-term strategy to transform its business by enhancing its use of data and technology. It has committed to implementing fundamental changes to its business model designed to have a lasting impact. A great deal of HMRC's energy and focus over the next five years will be to automate its systems and migrate more taxpayers into digital channels in order to increase its efficiency and effectiveness. Its strategy places considerable emphasis on doing more to help taxpayers get their tax right first time.

**7** If successful, these measures will increase the amount of tax HMRC collects through its standard processes, allowing an increasing proportion of its expertise to be devoted to tackling those who deliberately break the rules. As we reported in July 2015, HMRC's plans for change are ambitious and carry with them significant delivery risks.<sup>1</sup>

## **The nature and scale of tax fraud**

**8** **There is a wide range of ways in which people break the law by not paying taxes that are due.** HMRC has defined three main behaviours (**Figure 2** overleaf):

- evasion, where individuals or businesses omit, conceal or misrepresent information to reduce their tax liabilities;
- participation in the hidden economy, where an entire source of income is not declared; and
- criminal attacks, where organised criminals carry out coordinated attacks on the tax system such as smuggling goods to evade excise duty or fraudulently generating repayments of tax.

We use the term 'tax fraud' in this report as a generic term to refer to these behaviours (paragraph 1.3).

**9** **HMRC estimates that losses to tax fraud amount to £16 billion each year.**

This is nearly half of HMRC's current estimate of the tax gap (£34 billion). The tax gap is only an estimate, but it is the best data available on the amount of tax lost, including through tax fraud. The losses HMRC attributes to evasion, the hidden economy and criminal attacks have fluctuated from year to year but the overall trend in tax fraud is flat. HMRC estimates that losses from tax fraud accounted for 3.2% of all tax due in 2009-10 and 3.0% in 2013-14 (paragraphs 1.6 to 1.7).

<sup>1</sup> Comptroller and Auditor General, *HM Revenue & Customs 2014-15 Accounts, Report by the Comptroller and Auditor General*, National Audit Office, July 2015.

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## Figure 2

### Tax fraud

#### HMRC has identified three types of behaviour

Behaviour	Examples
Evasion	Stating that your income is lower than it is in a self-assessment tax return.  Not disclosing income or assets held offshore.
Hidden economy	Not telling HMRC about a main source of income, such as a job paid cash-in-hand.  Not telling HMRC about a secondary source of income such as money from renting out a property.
Criminal attacks	Smuggling genuine or counterfeit products, such as alcohol or tobacco, into the UK to evade duties.  Cyber attacks on HMRC systems to fraudulently claim tax repayments.

Source: National Audit Office analysis of HM Revenue & Customs documents

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**10 HMRC has assessed that two groups, smaller businesses and criminals, are responsible for 17 of the 21 biggest risks relating to tax fraud.** HMRC has identified over 50 large and strategic risks to the collection of tax. 21 of these risks relate to tax fraud. An example of such a risk is small businesses failing to register for VAT when their turnover exceeds the threshold for registration. Of the 21 risks, 8 relate to organised crime and 9 involve medium-sized, small or micro-businesses. HMRC believes that these businesses are responsible for tax losses of £17 billion, almost half of its estimate of the total tax gap, but it does not consider its internal estimate of how much of this is the result of tax fraud robust enough for publication (paragraphs 1.8 to 1.11).

### How HMRC tackles tax fraud

**11 HMRC has changed its approach to enforcement and compliance in response to pressures to make savings and then to increase revenues.** Between 2006 and 2011, HMRC invested in technology and retrained staff to allow it to better direct its activities towards the areas of greatest risk, based on improved data to detect non-compliance and a better understanding of taxpayer behaviours. This allowed it to reduce headcount. From 2010, it recruited and trained more staff to expand its coverage of all taxpayer groups, in particular small and medium-sized businesses, and ran a five-year campaign to increase the number of prosecutions. In 2014, HMRC refocused its strategy to concentrate more on the things it can do earlier in the cycle to promote compliance with tax law and prevent tax fraud and tax avoidance, while dealing more robustly and effectively with tax fraud when it occurs. HMRC is still developing this strategy (paragraph 2.4).

**12 HMRC uses a range of interventions to tackle tax fraud.** HMRC's activities to tackle tax fraud include: running publicity campaigns and other forms of communication to 'nudge' taxpayers towards acting honestly; encouraging tax evaders to voluntarily settle their tax affairs using disclosure facilities; using taskforces to target particular risks; undertaking civil investigations to gather evidence of tax fraud; and pursuing criminal investigations with a view to prosecution. These activities sit within HMRC's overall approach to tackling non-compliance by taxpayers, which is threefold: to promote compliance with tax law, such as by making it easy for taxpayers to comply with their tax obligations; to prevent non-compliance before it occurs; and to respond robustly to recover lost tax revenue (paragraphs 2.8 and 2.10).

**13 HMRC has achieved its revenue target from all compliance work, but has only partial data on how much revenue was protected by its work to tackle tax fraud.** In 2010, HMRC was set a target to increase the yield from its compliance work by £7 billion by 2014-15. This target included the additional revenue HMRC could generate from tackling tax fraud and all other forms of non-compliance, such as simple error and legal but contrived arrangements to avoid tax by exploiting loopholes in tax law. It reported additional revenue of £26.6 billion in 2014-15, exceeding its target by £0.6 billion. HMRC does not record compliance yield in a way that identifies what proportion of the total yield is derived from all its activities to counter tax fraud. For example it has more complete information on the yield from its work to tackle organised crime than tax evasion. We estimate that between 30% and 40% of compliance yield may be generated by HMRC's activities to tackle tax fraud, based on HMRC's analysis of the compliance yield it can attribute to the largest tax risks. This is a crude estimate based on partial evidence, and we will look for firmer evidence of HMRC's impact as we evaluate its response to different aspects of tax fraud in our future work (paragraph 2.15).

**14 It is inherently challenging for HMRC to understand whether it is using the best mix of measures to tackle tax fraud in the long term.** HMRC uses compliance yield as a direct measure of the effectiveness of its compliance work, while its annual tax gap calculation provides an indicator of the long-term impact of HMRC's work overall. However, it is difficult for HMRC to know how its interventions interact with one another or whether it is achieving the best outcome from the resources it deploys to tackle tax fraud in the round. It is also hard to detect or quantify potential unintended consequences of its compliance work, such as whether disrupted criminal activity is displaced to other gangs, or the long-term effect on taxpayers' behaviour of encouraging tax evaders to volunteer information about their income and assets so they can benefit from lighter penalties than might otherwise have been imposed. The problem of measuring outcomes is one faced by all tax administrations worldwide. HMRC recognises this complexity and is developing its thinking on how to design a new range of performance measures that will give it a better understanding of the impact from its work (paragraphs 2.17 to 2.21).

## **HMRC's approach to civil and criminal investigations**

**15 HMRC prioritises recovering the tax lost as a result of tax fraud, and uses civil investigations in the majority of cases.** HMRC will usually encourage the taxpayer to cooperate so it can collect tax that is due. It believes that using its powers to investigate tax fraud by civil means is usually the best way to recover the missing tax at the lowest cost. It imposes fines and other sanctions to punish and deter deliberate evaders. HMRC's approach reserves criminal investigation and prosecution for cases where it believes it needs to send a strong deterrent message or when, given the severity of the fraud, it considers prosecution the only appropriate action. HMRC always seeks to prosecute organised criminal gangs (paragraphs 3.3 to 3.4).

**16 HMRC has met its target to increase prosecutions, but recognises that it needs to better prioritise the cases it selects for criminal investigations.** HMRC agreed a target to increase prosecutions by 1,000 a year by 2014-15. Although HMRC cannot demonstrate that this was the right number, the target had the effect of prompting it to change its processes and make its investigations more efficient. This led it to focus on less complex cases, in particular a large number of prosecutions for evading income tax, VAT and tobacco duty, and lower-value cases. HMRC has recognised that it needs to align the cases it selects for criminal investigation more closely with its analysis of risk and how effective a successful prosecution would be in creating a deterrent. It is introducing internal guidance to achieve this (paragraphs 3.14 to 3.17).

**17 HMRC has more to do to understand what benefits it has achieved by increasing the number of prosecutions.** The main reason for increasing prosecutions is for the deterrent effect it may create; that is, a credible threat of criminal prosecution may deter people who would otherwise have committed tax fraud from doing so. In 2014-15, HMRC claimed £295 million in yield from the deterrent effect of its additional 1,000 prosecutions. However, in 2015 HMRC evaluated the deterrent effect of these prosecutions and found it could not verify their monetary value. The deterrence effect is inherently difficult to evidence. HMRC has therefore commissioned a range of research methods including surveys, interviews and data analysis. HMRC's surveys found an increased awareness of prosecutions, but it proved difficult to evidence changes in behaviour or increases in tax revenues from prosecutions. HMRC has developed its understanding of the deterrence effect, but needs further information to determine the right type and number of cases to select for criminal investigation (paragraphs 3.19 to 3.21).



## Concluding remarks

**18** We welcome HMRC's readiness to think and act strategically about the future of its business, the main focus of which we have summarised in paragraphs 5 to 6. We encourage HMRC to step back and take a more fundamental look at the enforcement and compliance part of its business, and in particular to strengthen its understanding of the long-term impact of its actions on those who seek to break the rules. Designing an approach to tackling deliberate non-compliance that raises revenue efficiently and effectively requires any tax authority to ask and answer some fundamental questions. These include:

- What is the right balance between pre-emptive measures to promote tax compliance and post-hoc interventions to identify and tackle non-compliance?
- What is the optimal level of enforcement coverage?
- What is the role of punishment and enforcement when the rules have been broken?
- What should be the balance between measures that maximise revenue in the short term and those with a more long-term impact on reducing the tax gap?
- What are the costs and benefits of different types of activities?

**19** HMRC has processes and approaches in place to respond to non-compliance, many of which are well established and longstanding. However, it is healthy for any organisation to challenge received ways of doing things. There are no perfect answers to these questions but HMRC should be able to explain and justify its choices. Like any tax authority, HMRC faces competing pressures and constraints, and putting resources into work in one area means not doing something else. It must fulfil its objectives within tight funding requirements. Different governments have different priorities and HMRC must respond to these. HMRC must also respond to unpredictable economic pressures and the expectations of taxpayers and the wider public. This leaves it with some difficult judgements to make about the balance of its compliance activities; we illustrate some of these in **Figure 3** overleaf.

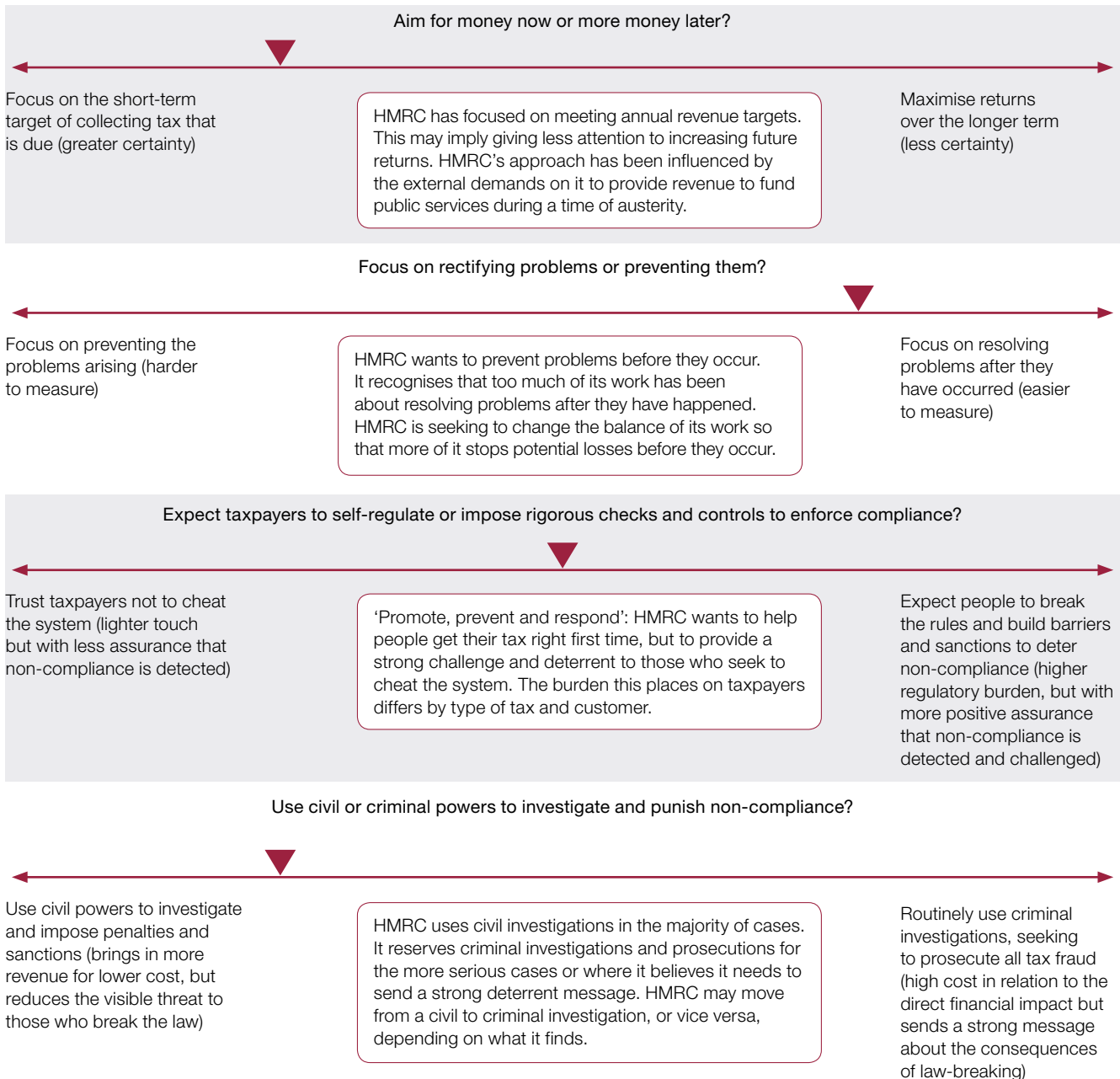
**20** HMRC has achieved the targets to raise extra revenue from its compliance work that were set in the 2010 Spending Review. While we recognise the significance of this achievement, we consider HMRC's approach has been to make incremental and tactical changes which was a rational response to the need to raise more tax revenue in the short term during a time of austerity. HMRC will only achieve value for money if the choices it makes take sufficient account of long-term outcomes.

**21** We believe HMRC has started to take a more strategic view of its compliance business, but needs to go further. It has begun to shift the balance of its work, placing increasing emphasis on measures to prevent non-compliance rather than relying so much on investigating it afterwards. It is working to improve the way it collects and analyses data. For example, it has improved its assessment of tax risks, and is seeking to link this analysis more explicitly with the compliance yield it achieves and its decisions about where to deploy resources. Alongside these positive steps, we encourage HMRC to do more to strengthen the evidence that underpins its decisions, and to develop a clearer view of what would be the optimal balance of compliance activities based on sound data, analysis and judgement.

**Figure 3**

An illustration of the judgements tax authorities must make about the balance of compliance work

All tax administrations face trade-offs in deciding their approach to promoting compliance with tax law. There are no right answers.<sup>1</sup> This figure is illustrative only, and does not depict a series of choices that HMRC recognises or considers in designing its compliance business.<sup>2</sup>



▼ 1 National Audit Office's judgement of the balance of HMRC's compliance effort between 2010-11 and 2014-15. This is not intended to imply a qualitative judgement about which point on the scale is best, nor does it indicate where HMRC aspires to be in the future.

2 HMRC asked us to include the following text: "HMRC disagree with this model and the National Audit Office's interpretation that there is a choice to be made between the activities outlined above. Effective administration of the tax system is about seeking to optimise all and HMRC's view is that this presents a too simplistic view of the balance of judgements that have to be made".