

Analysis

# Measuring Tax Gaps 2023: analysis and predictions

Speed read

HMRC has published *Measuring Tax Gaps 2023* (their annual summary of the tax they haven't collected). Another strong performance for HMRC raises interesting questions about what HMRC might do next. The data suggests two things: first, that reducing the tax gap further isn't going to be easy; and second, that HMRC are likely to focus more on the 'large businesses' segment of customers.



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Unless your principal private residence happens to be under a rock, you will have noticed that the Treasury is short of cash and borrowing is becoming much more expensive. The pressure will be on HMRC, perhaps more than ever, to collect every penny of tax it can.

This is why – *contra* the views of most of my friends – the spreadsheets in 2023's *Measuring Tax Gaps* publication made wonderful by-the-beach reading this summer. What they lacked in narrative, style or 'buy one, get one half price' appeal was amply compensated by what they told you about the experience taxpayers will have of HMRC in the coming years.

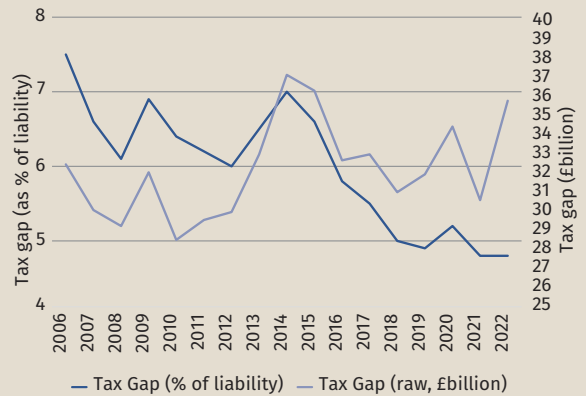
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The 'tax gap' is the difference between the amount of tax HMRC believes it should collect and the amount it actually collects – whether because of (for example) simple non-payment by the taxpayer, fraud, avoidance or 'legal interpretation'. The latter term describes good-faith disagreement between taxpayers and HMRC about the amount of tax that is properly due: for example, whether a taxpayer has satisfied the conditions for a particular relief. The overall tax gap has been on a downward trajectory for years as a percentage of liability, so one can forgive HMRC's self-laudatory press releases. The job of reducing the tax gap is the province of the various HMRC enforcement departments.

The tax gap has narrowed meaningfully over time as a proportion of liability and has sat for two years at 4.8%. There have been rather greater fluctuations in the raw tax

gap: in the past four years, it has been £32.1bn, £34.5bn, £30.8bn and now £35.8bn. Both measures of the tax gap are helpful: the former tells us about the efficiency of HMRC and the latter has greater implications for government spending.

Tax gap over time



The successful reduction of the tax gap over time is likely attributable to a number of factors: investment in personnel, plentiful post-2014 anti-avoidance legislation, the prominent role of the customer compliance manager for Large Business, and increasing international data sharing agreements. It is much harder today not to pay tax that is due. Credit is due to HMRC for their appetite for enforcement, though advisers will remain keen to spot the signs of HMRC overreaching in certain cases.

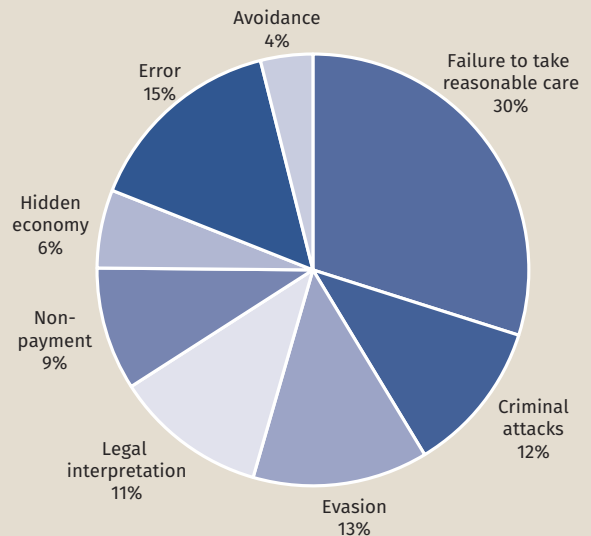
So, having (literally) banked this success, what will be HMRC's enforcement priorities in the coming years?

I want to offer two propositions, each based on the data. First, reducing the tax gap further isn't going to be easy; and second, HMRC are likely to focus more on the 'large businesses' segment of customers.

Reducing the tax gap isn't going to be easy

The first thing to understand is the composition of the tax gap. Taking the most recent figures from *Measuring Tax Gaps*, the £35bn tax gap comprises as follows:

Causes of the tax gap



Most of these terms are self-explanatory. The distinction between ‘error’ and ‘failure to take reasonable care’ goes to the issue, relevant for the purposes of determining whether a penalty is chargeable under FA 2007 Sch 24, of the taxpayer’s culpability in making an error. ‘Criminal attacks’ refers to ‘coordinated and systematic attacks on the tax system’ (the examples given are smuggling of tobacco and large-scale VAT fraud such as MTIC). The ‘hidden economy’ is activity that is not declared to HMRC: from the trader who fails to register for VAT to the office worker whose Etsy ‘side-hustle’ is not declared as income.

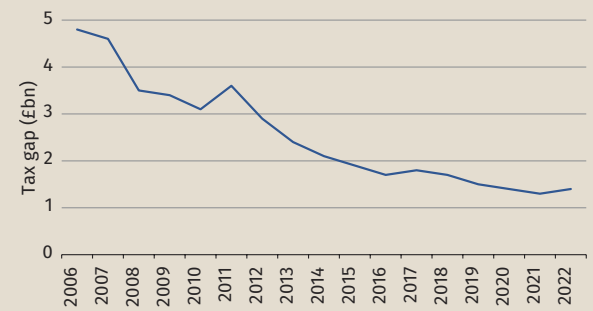
There might be room for some improvement. For example, the very large ‘failure to take reasonable care’ category might benefit from targeted HMRC information campaigns and support. (The temporary closure of the self-assessment helpline is perhaps not what I have in mind.) In any case, HMRC might be consoled that this element of the tax gap does at least return some funds to the Treasury, because of the ability to assess penalties. Equally, new reporting rules for digital platforms (the UK’s version of DAC 7) might help to pick up the aforementioned online small businesses and guide them into paying tax. Yet these are little victories, and often come at significant cost.

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Other areas are harder to address. For example, the ‘error’ category by definition describes a loss of tax brought about notwithstanding the reasonable care of the taxpayer. Perhaps there are technological solutions that might ameliorate the problem to some degree, but the unhappy experience of Making Tax Digital suggests that IT is not a panacea. Equally, criminal gangs might not respond differentially to new legislation, so HMRC’s worthwhile efforts in this space will require regulators and law enforcement as a whole to put in the hard yards. No easy fix there either. The same probably applies to evasion: HMRC’s task in dealing with evasion is to identify when it is being lied to, and while behavioural deterrents (penalties, the possibility of prosecution, etc.) might go some way to persuading taxpayers to tell the truth, and an increase in use of data and information-sharing between authorities might help to detect deception, there is only so much HMRC can and should do. The largest driver of non-payment is insolvency, which is not something HMRC can cure (indeed, it’s often enough HMRC that initiates formal insolvency processes).

No-one likes tax avoidance, but HMRC has already done considerable work to reduce its prevalence. It declined sharply from 2006 to 2018 on the back of significant changes in the approach of taxpayers and the powers of HMRC, and has since largely plateaued. The scope to tackle avoidance further might therefore be limited.

Avoidance tax gap: 2006 to 2022



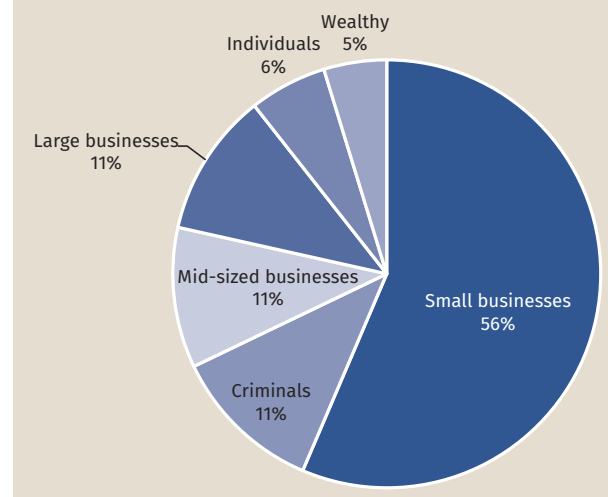
The ‘legal interpretation’ tax gap poses a different challenge. First, unless one asks HMRC, it must be smaller than the figure presented. That is because ‘HMRC’s interpretation of the law and how it applies to the facts in a particular case’ will sometimes be incorrect. So, while HMRC’s balanced approach in the litigation and settlement strategy – of seeking to litigate strategically and based on legal advice – is typically appropriate, HMRC could never succeed in reducing this element of the tax gap to zero.

Given HMRC’s limited ability to reduce many aspects of the tax gap, whom are they likely to target?

#### Large businesses

The tax gap is overwhelmingly attributable to small businesses: some £20.2bn in 2021/22, well over half of the total. Large businesses represent a far smaller proportion (around 11%).

Tax gap by taxpayer



One could be forgiven for thinking that, on that basis, HMRC would look to small businesses as a major target for enforcement. It is hardly surprising, however, that there is a bigger tax gap for small businesses than for large businesses: there are millions of small businesses and only 2,000 taxpayers in the large business category. HMRC have published the number of taxpayers in each category (see *Tax by different customer groups – 2021 to 2022*). That suggests a much larger tax gap is attributable to each large business taxpayer.

Type of taxpayer	Number of taxpayers	Tax gap (£bn)	Tax gap 'per taxpayer'
Small businesses	5,300,000	20.2	£3,811
Mid-sized businesses	270,000	3.8	£14,074
Large businesses	2,000	3.9	£1,950,000
Individuals	32,000,000	2.1	£66
Wealthy	800,000	1.7	£2,125

This is perhaps not surprising: large businesses are, by their nature, large (as a general rule, they have turnover exceeding £200m or £2bn in assets).

Aside from the much larger median tax gap for each large business taxpayer, might HMRC be said to be 'leaving money on the table' in their enforcement activities? The 2021/22 annual report reveals that compliance spend is lower for large businesses (£260m) than for mid-sized (£270m) and small (£550m) businesses and individuals (£410m). Only the 'wealthy' category (£220m) receives less enforcement funding. Of course, that £260m is still £130,000 per large business taxpayer (a far higher spend than on any other group, and presumably reflective, at least in part, of the costs associated with the activities of the customer compliance manager), and perhaps is enough to do the job – but given the size of the tax gap for large businesses, HMRC might well choose to allocate more and carry out more enforcement activities.

There are further reasons why large businesses might find themselves subject to increasing HMRC scrutiny. HMRC will know – because of its customer compliance management scheme and regular risk reviews – far more about the activities of large businesses than other categories of taxpayer. They are likely to operate internationally, so HMRC will have access to significant data from other jurisdictions. Large businesses typically have developed tax, finance, legal, and compliance teams, so HMRC might expect much more meaningful engagement over tax questions. Reputational risks relating to tax may be greater for larger businesses. And large businesses do not suffer from the same level of insolvent business failure that characterises smaller businesses (and, presumably, leads to the 'non-payment' element of the tax gap).

## All of this means that large businesses will look like a 'soft target' to HMRC

All of this means that large businesses will look like a 'soft target' to HMRC, and should therefore be prepared for further scrutiny of their tax affairs. It's not going to get any easier for tax and compliance departments just yet. ■

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▶ HMRC's evolving approach to tax compliance for large businesses (N Newbury, 7.9.23)