Tax evasion in retail: National Audit Office report

OMB Indirect Tax



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Electronic sales suppression and phoenixism are estimated to cost the Exchequer £950 million a year in lost taxes.

Key Points

What is the issue?

The National Audit Office has released a report which assesses HMRC's overall approach to tax evasion in retail. It is critical of HMRC for not having a strategy for addressing tax evasion.

What does it mean for me?

Advisers may be asked to support their clients through a nudge letter or enquiry, so need to be aware of the circumstances which could prompt HMRC to make enquiries

and the options available to resolve the issue.

What can I take away?

HMRC estimates that £450 million is lost annually to electronic sales suppression and £500 million is lost annually to phoenixism so the retail sector is likely to come under increased scrutiny in the future. Knowledge of HMRC's disclosure processes and working with specialist advisers in tax disputes is often necessary for effective resolution with HMRC.

The National Audit Office (NAO) published its comprehensive report titled 'Tackling tax evasion in high street and online retail' on 9 September 2024 (see tinyurl.com/2e9mhnbv). The report discusses whether HMRC, alongside other relevant parts of government, are suitably placed to tackle tax evasion in the retail sector.

Its conclusion is somewhat critical of HMRC, and in particular finds, amongst other things, that 'significant weaknesses remain in government systems which tax evaders can easily exploit' and that HMRC has so far lacked an effective strategic response in tackling tax evasion in small businesses.

When discussing whether HMRC is offering value for money, the NAO concludes that 'tax evasion has been growing among small businesses, and HMRC has so far lacked an effective strategic response'. The report highlights widely used methods of evasion, such as sales suppression and phoenixism, which it identifies as 'large and potentially growing'.

The NAO notes that tackling tax evasion is not straightforward, but that HMRC needs to work with other stakeholders to find the most cost-effective way to reduce evasion. The report concludes that tighter controls and more compliance work would be likely to raise significant sums, and that they would be both cost effective and improve value for money.

With this in mind, it is useful to understand the scale of tax evasion. HMRC estimates that tax evasion cost £5.5 billion in lost revenue in 2022/23 (14% of the total tax gap); and £4.4 billion of this sum occurs in small business (81% of all evasion).

The NAO report and tax evasion

The NAO sought to assess HMRC's overall approach to tax evasion in retail and looked at specific areas:

- contrived business insolvency and phoenixism;
- VAT evasion by overseas retailers selling through online marketplaces; and
- electronic sales suppression.

We focus on two of these areas: electronic sales suppression and phoenixism.

Electronic sales suppression

Electronic sales suppression involves the use of software installed on till systems which is designed to reduce the recorded turnover of the business, whilst providing what appears to be a credible and compliant audit trail.

HMRC has increased its compliance activity in this area. Notably, in late 2022 it raided nine premises in the Midlands and five criminal arrests were made of individuals suspected of selling electronic sales suppression software in the UK. This in turn led to HMRC targeting 90 businesses across the UK suspected of using the software and there were also overseas connections with similar enforcement action in the USA and Australia.

More recently, HMRC activity has been less high profile and has been focused on its go-to tool of nudge letter campaigns (discussed further below). However, the NAO suggests that HMRC is not giving sufficient priority to this issue.

Further, it appears that HMRC is not yet using the significant new electronic sales suppression penalties which are available to it. The powers contained in the Finance Act 2022 include specific information powers enabling HMRC to obtain details of those involved in the electronic sales suppression supply chain and traders suspected of or using the electronic sales suppression tools.

Schedule 14 of Finance Act 2022 now empowers HMRC to impose civil penalties of up to £50,000 each for the making, supply and promotion of electronic sales suppression software and hardware. An unlimited number of penalties of up to £50,000 each can be charged to the same person if they:

- promote the electronic sales suppression ‘tool’ (i.e. physical devices, software, computer code, etc) on more than one occasion; and/or
- design, promote and supply an electronic sales suppression tool, as they may be liable to all three types of penalties.

The penalties can be levied on any person meeting the conditions – so employees who develop or sell an electronic sales suppression tool as part of the terms of their employment could also be penalised.

HMRC may also impose a penalty of up to £1,000 for the possession of or having access to an electronic sales suppression tool, although if it is removed within 30 days the penalty can be mitigated.

Phoenixism

The NAO report points out that HMRC is not making full use of its powers to tackle ‘phoenixism’, which it defines as the practice of carrying on the same business through a series of companies, where each becomes insolvent only to continue trading as a new separate company to deliberatively evade paying debts, including tax liabilities.

HMRC does have powers to pursue directors for company debt where it considers they are declaring insolvency to avoid paying tax and has powers to require securities against future tax liabilities for successor companies, where it determines there is a risk of tax loss. However, it is not clear how successful HMRC has been in using these powers because, as the NAO points out, in HMRC’s 2023/24 annual report, whilst it reported partial results of its activity, it did not give a clear overview of its performance or impact.

NAO’s findings

Interestingly, HMRC’s own tax gap analysis estimates that £450 million and £500 million respectively are lost to electronic sales suppression and phoenixism annually. It is therefore surprising that the NAO has found that HMRC is not fully prioritising compliance activity in these areas.

The NAO found that: ‘HMRC does not know how successful it is in tackling tax evasion, in aggregate or for particular taxpayer groups… It does not have a systematic way to identify and share wider learning from these evaluations or use them to consider its overall impact in tackling tax evasion or feed lessons on what works well into its plans.’

The NAO acknowledges that HMRC’s overarching strategy to tackle non-compliance by preventing it from occurring is sensible, and finds that real opportunities exist for HMRC to work more systematically across government to reduce evasion. However, the report states that ‘HMRC does not have a specific strategy for addressing tax evasion, focusing instead on tackling strategic risks of non-compliance to prevent the overall tax gap from increasing’. It goes on to say that HMRC’s approach may not sufficiently prioritise some pervasive forms of tax evasion, such as electronic sales suppression and phoenixism.

While the government plans to give HMRC additional resources to tackle enforcement issues and we can expect to hear more details in the Budget, specific plans for how HMRC will approach retailer compliance may come later. HMRC will be updating its estimate of the scale of electronic sales suppression tax losses in December 2024, so this might also be an opportune time for it to lay out its strategy and action plans in this area.

Handling compliance activity

Readers may be aware that HMRC commenced a One to Many (or nudge letter) campaign in 2023 connected to electronic sales suppression.

In a positive step, the NAO report sets out that HMRC estimates that compliance yield from its work on electronic sales suppression increased from £17 million in 2022/23 to £98 million in 2023/24, due to increased focus and casework (from 253 cases to 1,275).

The nudge letter allows taxpayers to either voluntarily come forward to disclose any irregularities as a result of misusing till systems or to confirm that no such irregularities exist.

As with any nudge letter campaign, if taxpayers simply ignore the letter and take no action then they can be reasonably certain that HMRC will write again and/or

undertake its own investigation. Given the fact that the misuse of till systems is widely regarded as fraud, such action could extend to HMRC opening civil fraud enquiries under Code of Practice 9 or even the instigation of criminal proceedings.

HMRC has an electronic sales suppression disclosure facility available to businesses which wish to disclose their ‘misuse of a till system’ and its nudge letters also direct taxpayers to this. So far, there are no statistics made publicly available regarding the use of this online disclosure facility.

However, a key point that advisers should note is that it is limited to disclosing only unpaid tax arising from sales suppression. As a consequence, this facility may not be suitable for taxpayers who come forward with other matters to disclose. In our experience, and that of HMRC, where there has been fraud or evasion it is seldom limited to a discrete tax issue and settlements frequently cover a number of tax errors.

Similarly, given the nature of the matters that are likely to be disclosed (i.e. a level of tax fraud linked to sales suppression) it is likely that a more formal route, such as Code of Practice 9, may be more suitable. The crucial benefit to making a full and complete disclosure under Code of Practice 9 is that taxpayers receive immunity from criminal prosecution. As is usually now the case, the online disclosure facility set up for electronic sales suppression does not provide this protection.

In the 2023/24 tax year, HMRC opened only 268 Code of Practice 9 cases, as set out in HMRC’s latest figures (see tinyurl.com/y4wpbmmj). However, making use of Code of Practice 9 for electronic sales suppression could potentially help to recover the tax lost and help to close the tax gap caused by this evasion.

Accordingly, where taxpayers receive an electronic sales suppression nudge letter from HMRC, it is essential that specialist advice is obtained to ensure the correct disclosure route is taken in the circumstances, see CIOT’s guidance (see tinyurl.com/5n98d222).

Summary

The NAO is critical of HMRC’s approach to tax evasion in high street and online retail and the numbers do indicate that there is much unpaid tax to collect.

Given the findings of the report, and the additional resources that HMRC is expected to receive, it is likely that we will be seeing increased levels of HMRC compliance activity in the retail sector.

It will also be interesting to see if the Budget in October 2024 offers any specific commentary on HMRC compliance activities and whether the government sees even greater scope for increasing the tax take by investing in HMRC’s enforcement teams.

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