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**Tax  
Research  
UK**

**In the shade:  
Research on the UK's missing economy  
May 2014**

**Richard  
Murphy**

# In the shade: research on the UK's missing economy

May 2014

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## 1. Executive summary

Tax gaps exist in all economies. This gap needs to be as small as possible to enable healthy and robust government spending. However this requires all people and companies to willingly pay the tax they owe. This research highlights the fact that the UK currently makes it relatively easy to avoid paying tax, particularly for limited companies. As a result, the potential tax lost, which could be otherwise spent on essential government costs, is very significant and, according to these calculations, much larger than current HM Revenue and Customs (HMRC) estimates. The report takes a look at the UK's 'shadow economy' – what it is and how much it is costing. It makes recommendations about how to reduce the effect that the shadow economy and resulting tax lost is having on the country.

The UK tax gap is the difference between the tax that would be due if UK law operated as Parliament intended it and the amount of tax that is actually collected. There are varying estimates of this tax gap. HMRC, our national tax authority, estimate it to be £35bn.<sup>1</sup> This research suggests it could be much higher and seeks to explain how one significant part of the UK tax gap can arise, apparently unnoticed.

The focus of this report is the tax lost as a result of untaxed trading income: it does not consider the whole of the UK tax gap. By extrapolating data from HMRC and EU studies on VAT not paid, this report suggests that £100bn of UK trading income may not have been recorded in accounts sent to HMRC in 2011-12. It will investigate where these lost billions are.

The report examines the way that the 2.8 million or more UK companies that exist are taxed and regulated. It looks at how this seemingly dry topic is in fact of crucial importance to both the economy and society at large. It does not set out to challenge the benefits of the 'free market'; indeed, the report argues that a strong market economy is vital to the well-being of the UK but suggests that this free market is being undermined by the scale of tax evasion that exists in the UK and a lack of will on the part of governments to tackle this problem.

The report argues that this is because 'free markets' need regulation to be effective. For example, regulation ensures that businesses operate safely, sell products that will not harm their customers, and do not exploit their staff, the environment or the communities that effectively grant them their licence to operate.

Many of these necessary regulations are already in place. However, unless we can confidently identify which businesses are trading in the UK, the regulations cannot be effective. This report illustrates why it is currently difficult to identify many of the businesses to which these regulations should apply. As such it suggests that this whole edifice of regulation is at risk of falling down as a result. This, it is suggested, is a significant threat to 'free markets' and the UK's economic prosperity.

It is difficult to identify numbers of businesses because most of the UK market economy (in terms of value) is run through limited companies. As this report demonstrates, there is compelling evidence to suggest that we do not know which companies are trading in the UK. Of those we do know about, a great many are being lost without trace each year. What is more, many of these missing or 'shadow' companies disappear without paying the taxes they owe each year. As a result they are not being regulated and nor are they making a contribution towards the cost of regulation or to society at large.

This is important for a number of reasons. First, shadow companies undermine the prosperity that markets can generate. That is because these 'shadow companies' are creating an environment of unfair competition by undermining the honest businesses that pay their taxes. This in turn prevents honest businesses investing in their own expansion, in new products, in training, apprenticeships and better customer service. The overall effect is a reduction in the availability of good job opportunities and the creation of a long-term, sustainable economy.

Second, the report shows that the tax that these businesses should pay leaves an almost incomprehensibly large hole in the government's finances.

Third, what is then argued is that this hole in the government's funding has major repercussions for those who are dependent upon the state for their well-being.

Richard Murphy, this report's author, last considered these issues<sup>ii</sup> in 2011. Since then awareness of the 'tax gap' has increased enormously. There is also now more data available. As a result this report comprises new in-depth analysis of the proportion of the tax gap that can be attributed to shadow companies.

HMRC thinks that just less than nine per cent of VAT is unpaid after discounting for crime and bad debts. The EU thinks the figure is higher, and the UK Treasury forecast in December 2013 s that it would increase to more than 10 per cent over the coming years. Combining data from both the EU and HMRC' work on tax gaps it is clear that around £1 trillion of trading income should have arisen in the UK in 2011-12. If VAT is lost on about 10 per cent of all VAT-chargeable sales then it is highly likely that about 10 per cent of all sales, or £100bn per year in 2011-12, were unrecorded. VAT losses of the type noted here always relate to unrecorded sales.

This is an astonishing figure. It is the equivalent of about 6.6 per cent of the UK's total national income (given that total national income was about £1,500bn in 2011-12). However, peer reviewed studies by organisations like the World Bank suggest the UK might have a bigger shadow economy than this figure implies. A figure of 12.5 per cent is commonly suggested. The estimate made in this report is, therefore, well within known parameters of likelihood and totally consistent with HMRC's own data

This report's analysis of the data on lost VAT does however imply that the UK tax gap is much bigger than the HMRC estimate in total and that the total tax lost because of

unrecorded UK sales alone might have been £40bn in 2011-12. This will have risen by now and is forecast to rise quite significantly over the next few years based on Office for Budget Responsibility data.

Compared to this estimate for losses arising for this one reason, HMRC suggest that the total tax gap is £35bn. This report explores the reasons for this difference in view: by far the most important is that the estimate made in this report is based on macro-economic data whereas, with one exception, HMRC bases its data on a micro-economic approach.

The macro-economic approach adopted in this report estimates the tax (of all types) due on the total potential unreported income in the economy. This is a 'top down' approach. HMRC on the other hand bases its tax gap estimates for all non-VAT taxes on the errors they find in tax returns they receive. This means they do not, by definition, log errors in tax returns not received, or in those that they would receive only if they asked for a return. This is a 'bottom up' approach. The inevitable result is that the HMRC estimate of tax lost is much smaller since it is based on errors within the tax system rather than total tax lost from unrecorded trading within the economy as a whole.

The study looks at the use of limited companies as a possible explanation for the missing tax income. As a result of an extensive review of data from Companies House, HMRC, the Department for Business, Innovation and Skills and the Office for National Statistics, the report finds good grounds for believing that there are many shadow companies in the UK economy not declaring their trading income to HMRC. That conclusion is based on the following evidence:

- An average of more than 300,000 companies are struck off the Register of Companies each year without a formal liquidation process taking place;
- Each year, over 400,000 companies that could still owe tax are failing to file annual return forms with the Registrar of Companies, including those struck off;
- More than 340,000 sets of accounts due to the Registrar of Companies from companies that could still owe tax were not filed in 2012-13, including those due by companies struck off;
- At least 650,000 corporation tax returns a year are currently not requested by HMRC from companies that might be trading;
- 270,000 of the companies asked to submit corporation tax returns in 2011-12 did not do so;
- False declarations of income by smaller companies appear to be commonplace in at least 40 per cent of corporation tax returns submitted. If this number is extrapolated over the number of companies not being asked to submit tax returns or not submitting them, then a possible 360,000 companies may not be declaring income annually;
- US data suggests that under-declaration of income by the self-employed and smaller companies is commonplace and may exceed 40 per cent of real income, on average;

- Only 470 investigations of small company corporation tax returns were undertaken by HMRC in 2011-12, an effective rate of less than one for every 5,700 companies that might have submitted a corporation tax return in that year. Very few, if any, of these investigations appear to have been of companies that had not submitted corporation tax returns;
- Of the number of companies filing tax returns more than 500,000 said they did not trade;
- By the most generous of calculations just 41 per cent of all companies declared that they were trading in 2011-12 and fewer than that paid any tax;
- It is likely that at least 170,000 companies that trade do not declare that they have income for corporation tax purposes according to HMRC's VAT and PAYE statistics;
- The Office for National Statistics admitted it had miscategorised data on trading companies in 2013 and had to recategorise almost 500,000 sole company directors who were previously considered self-employed as employees of those companies. This indicates a serious under-estimate of the number of trading companies in the UK economy.

This evidence suggests that around 400,000 'shadow' companies might exist at any given time in the UK. It is important to stress that this would still leave at least 1.1 million dormant companies in the UK that do not trade (which is around the same number that do declare their income for tax purposes). Since the number of new UK companies is currently increasing at around 500,000 a year, the problem of shadow companies is likely to increase over time.

These 400,000 missing or 'shadow' companies provide one of the best possible explanations for where much of the UK's missing £100bn worth of trade is taking place although some of that missing trade will, of course, also be the undeclared and under-declared income of the self-employed and some will also be the undeclared income of companies that do actually submit corporation tax returns – which is a problem that HMRC admits exists, but overall this report suggests that the lax enforcement of regulation on small company tax and accounting makes it most likely that these entities are used for hiding this illicit trade.

In this context it is important to note that the average smaller company in the UK<sup>iii</sup> pays £13,000 a year in corporation tax. When the average self-employed person earns only £10,400 a year it is clear that the scale of activity in the small business corporate sector is much bigger than in the self-employed sector. VAT evidence supports this view since 95 per cent of all sales by value subject to VAT in the UK are made by companies. This report highlights that a significant part of tax loss to the UK government – amounting to a possible £23bn (in a range that may spread from a bit less than £20bn to over £26bn) may be due to companies operating in the shadow economy.

How do so many companies get away without paying tax? Companies House lax approach to enforcing company law makes it easy for companies to get away without recording and declaring their trading income. In addition HMRC is far too willing to believe that if companies do not submit corporation tax returns, they must be dormant (i.e. not trading).

The consequences of not collecting £40bn of tax a year are huge. Total UK government spending in 2013-14 was forecast to be £720bn. £220bn of that was on social security benefits, of which about £85bn went to the elderly, £42bn to people on low incomes, £37bn to families with children and £31bn to the sick and disabled.<sup>iv</sup> £137bn was to be spent on the NHS and £97bn on education. £40bn of tax lost as a result of the UK's unrecorded sales is, therefore significant and worth recovering.

The findings of this report will be used to recommend reforms to the system of company regulation and taxation that could improve the well-being of the poorest members of the UK's communities with whom Oxfam works.

## Recommendations

- HMRC should be provided with the resources it requires to tackle all tax evasion, which would include a considerably expanded tax investigation programme. This can only be achieved by investing more resources into the department and ending the programme of cuts and staff reductions that have been imposed upon it for a number of years;
- Banks and other financial services providers (including accountants and lawyers) who have a duty in money laundering law to identify the ownership of the companies for whom they act, should be required to report to HMRC and Companies House annually the identity of all the companies for whom they act that have bank accounts or other indications of trade, with bank account numbers being supplied;
- HMRC should be legally required to demand a corporation tax return from all companies if they have been advised that it is trading;
- HMRC should be given powers to approach banks and other financial service providers known to have had contact with a company if that company does not submit a corporation tax return within three months of the time allowed by law to require the provision of information, such as bank statements, that would let HMRC prepare estimated tax demands to be paid by the company in the absence of accounts and corporation tax returns;
- The tax liabilities of companies who have failed to submit tax returns to HMRC should be the personal liabilities of the directors of the company and all its owners who have more than 25 per cent of the share capital as well as the company itself. In this way the limited liability of companies would not permit deliberate tax abuse as it does at present because those responsible for that abuse would become personally liable to make payment of any sums they have defrauded;
- The proposed public register of the beneficial ownership of companies should be checked by Companies House with the data supplied to it by banks and other financial services providers to ensure that accurate information is published on that register. The annual return fee for companies (currently £13 a year) should be increased to cover the costs of checking and enforcing this disclosure. Increasing this fee to £30 a

year would increase the resources available to Companies House by almost 60% but also make sure it could do its job effectively, and help it to beat fraudulent use of companies in the UK;

- Companies House should not be allowed to strike off a company until that company has supplied accounts covering all its periods of trading;
- HMRC should be required to object to the striking off of any company whilst tax liabilities owing by it remain outstanding;
- HMRC and Companies House should be provided with the resources they need, including increased staffing, to enforce these laws since the cost of enforcement will be vastly less than the potential sums raised.

## 2. Introduction

### Objectives for this chapter

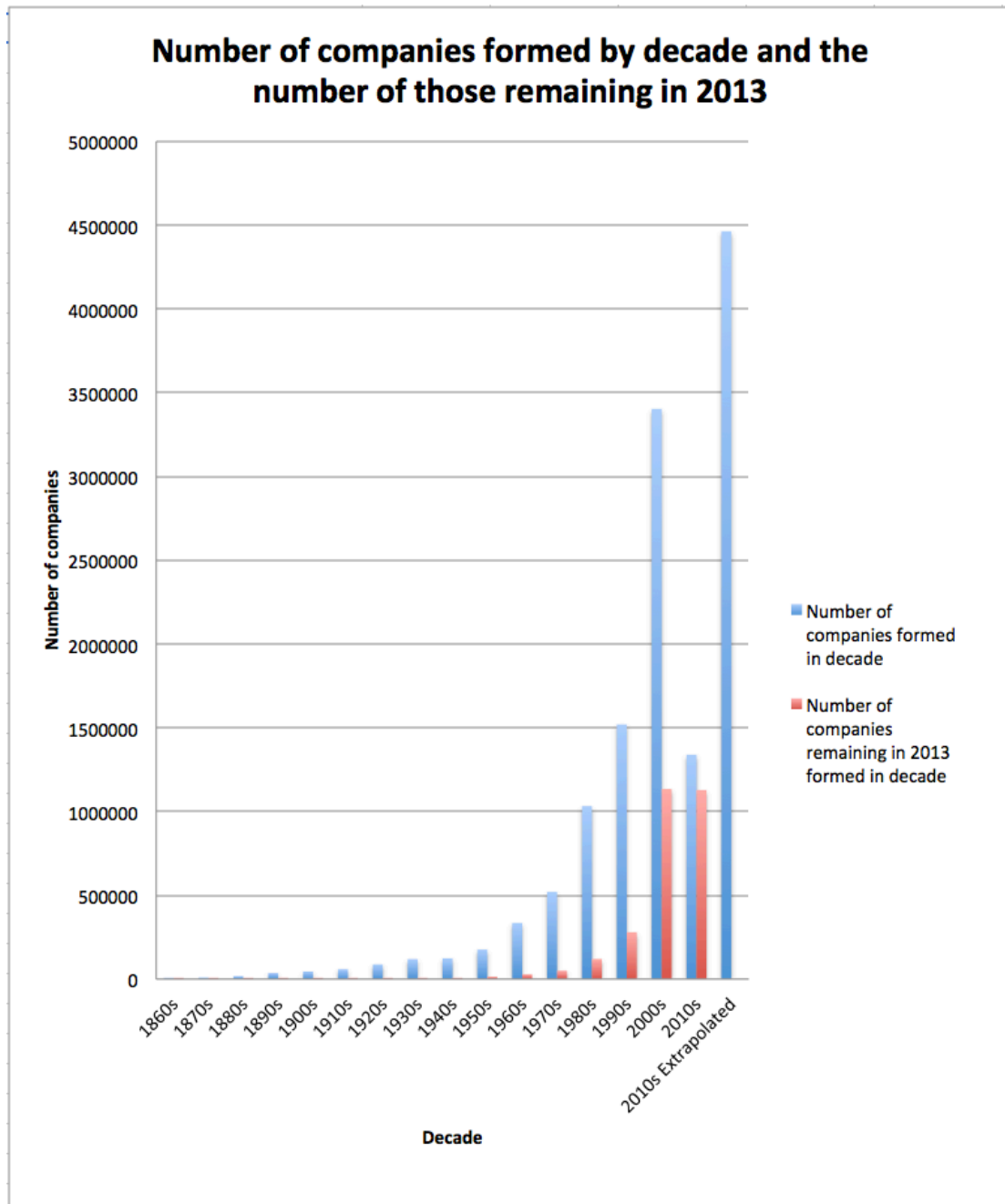
This report is about companies registered in the UK. Before getting into detail this chapter of the report seeks to do these things:

- Give some indication of the number of companies in the UK and how these numbers have changed over time;
- Explain what companies are used for;
- Suggest why the number of UK companies has increased so dramatically in recent years;
- Explain the obligations arising from using companies and why they exist.

Each of these themes is discussed under a separate heading in the rest of this chapter.

#### a. The number of companies in the UK – and how the numbers have changed over time

Companies have been formed in the UK under statute law, rather than by separate Acts of Parliament, since the 1860s. Figure 1 below shows the number of companies formed each decade since then and the number from each decade still surviving in 2013.



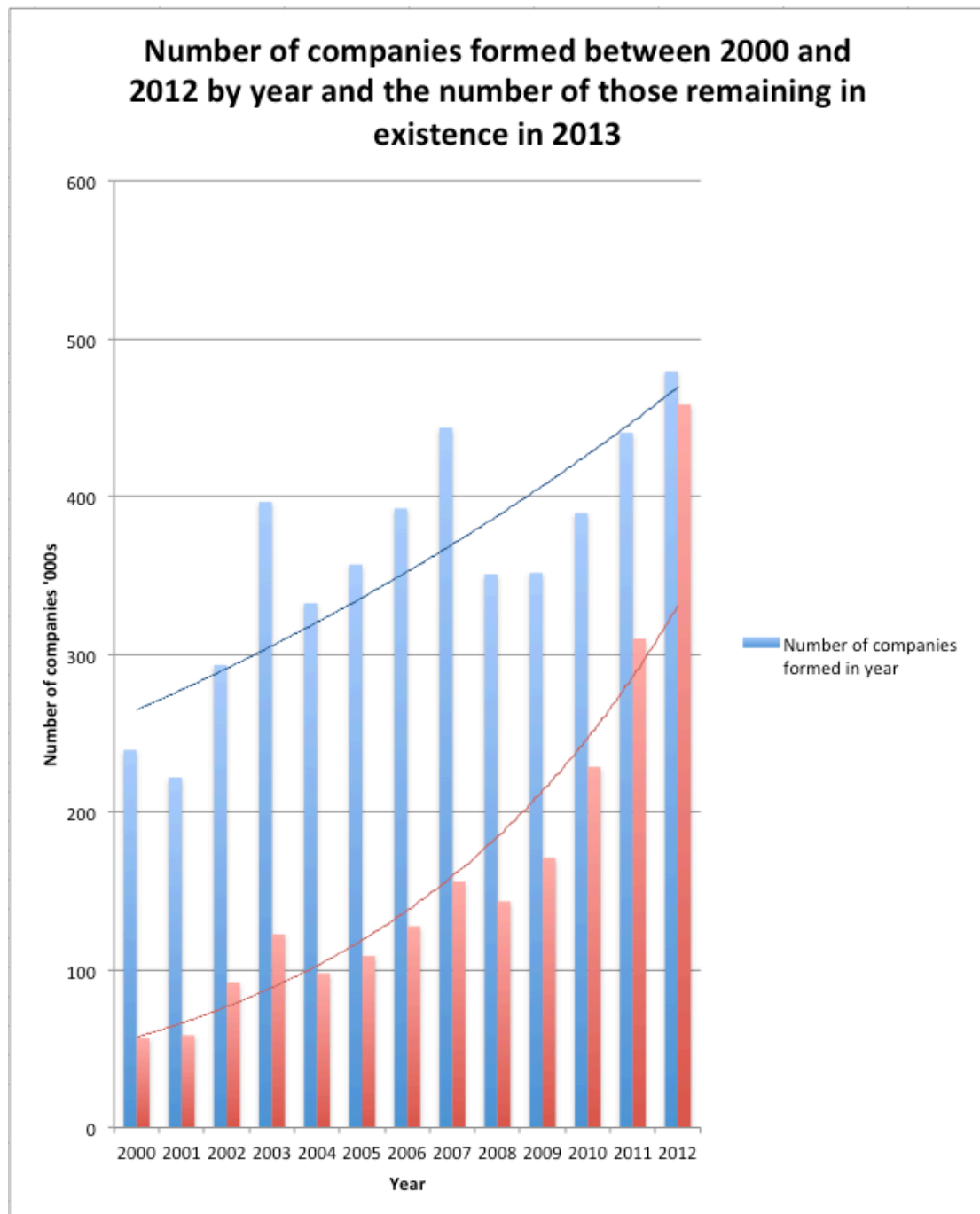
**Figure 1**

**Source: Companies House Annual Reports on Register Activity**

The data for the current decade has been extrapolated to show the likely outcome if the data for the period 2010-13 continues at the same pace for the rest of the decade.

The data is sparse in the 1860s and 1870s because just 5,000 companies were formed in the first decade of the law’s existence, and 9,900 in the second decade. By 2000 a total of 4.1 million companies had been legally formed. In the decade that followed almost 3.5 million were incorporated and the total now exceeds 8.8 million of which 7.3 million have been formed since 1980. By chance this means that there has been exactly one company formed for every three live births<sup>v</sup> in the UK since 1980. In the current century this ‘birth rate’ has increased, considerably.

In 2013 just 515,600 of all the companies formed up until 1999 remained in existence. Of the remaining 2.3 million companies, all had been incorporated since 2000. This indicates that almost 2.5 million of the companies formed since 2000 had already been dissolved by 2013—well over half of the number incorporated in that period. The era of the ‘throwaway company’ arrived this century. Figure 2 shows how low survival rates are.

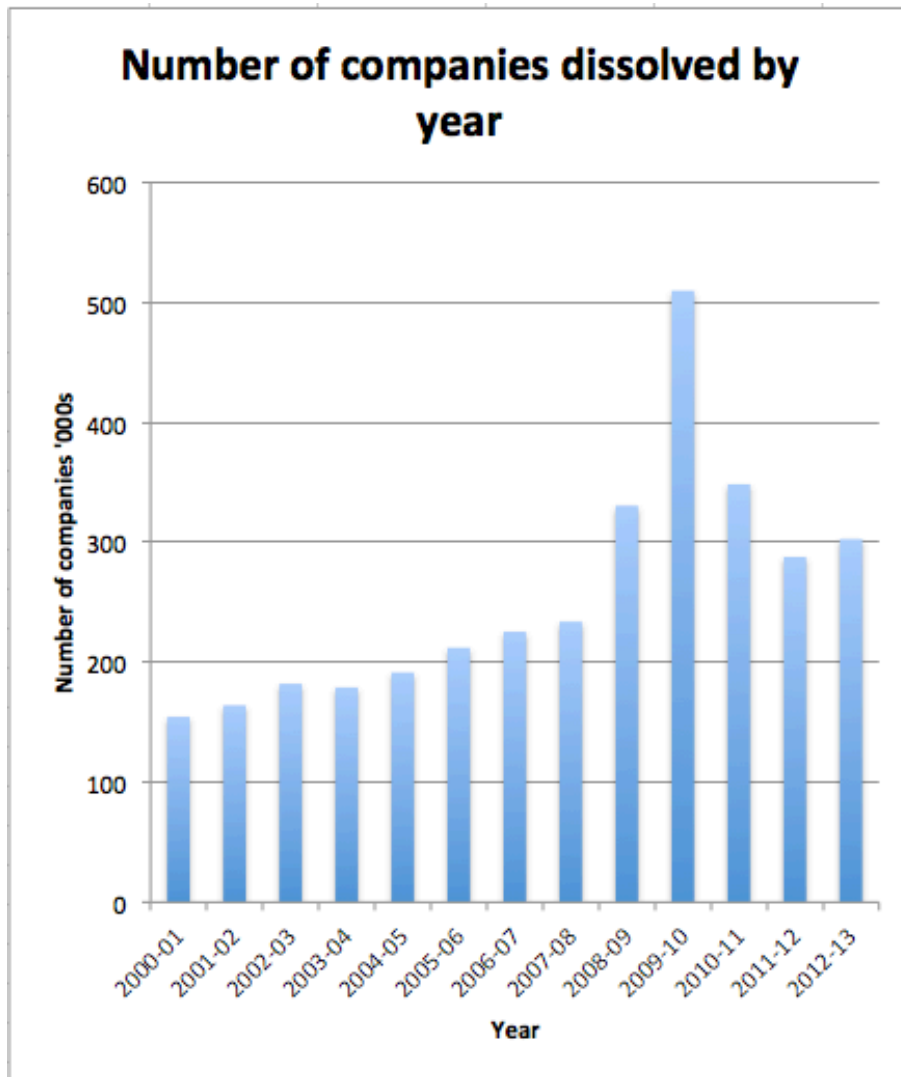


**Figure 2**

**Source: Companies House Annual Reports on Register Activity**

There was an explosion in the rate of company formation from 2002 onwards, reaching a peak in 2007. The recession then contributed to a decline in activity, but incorporation rates have now recovered to reach new record levels, mainly because more people have turned to self-employment and businesses start-ups as the recession has continued and employment prospects have been weak.

Figure 3 illustrates the high numbers of companies dissolved during this period.



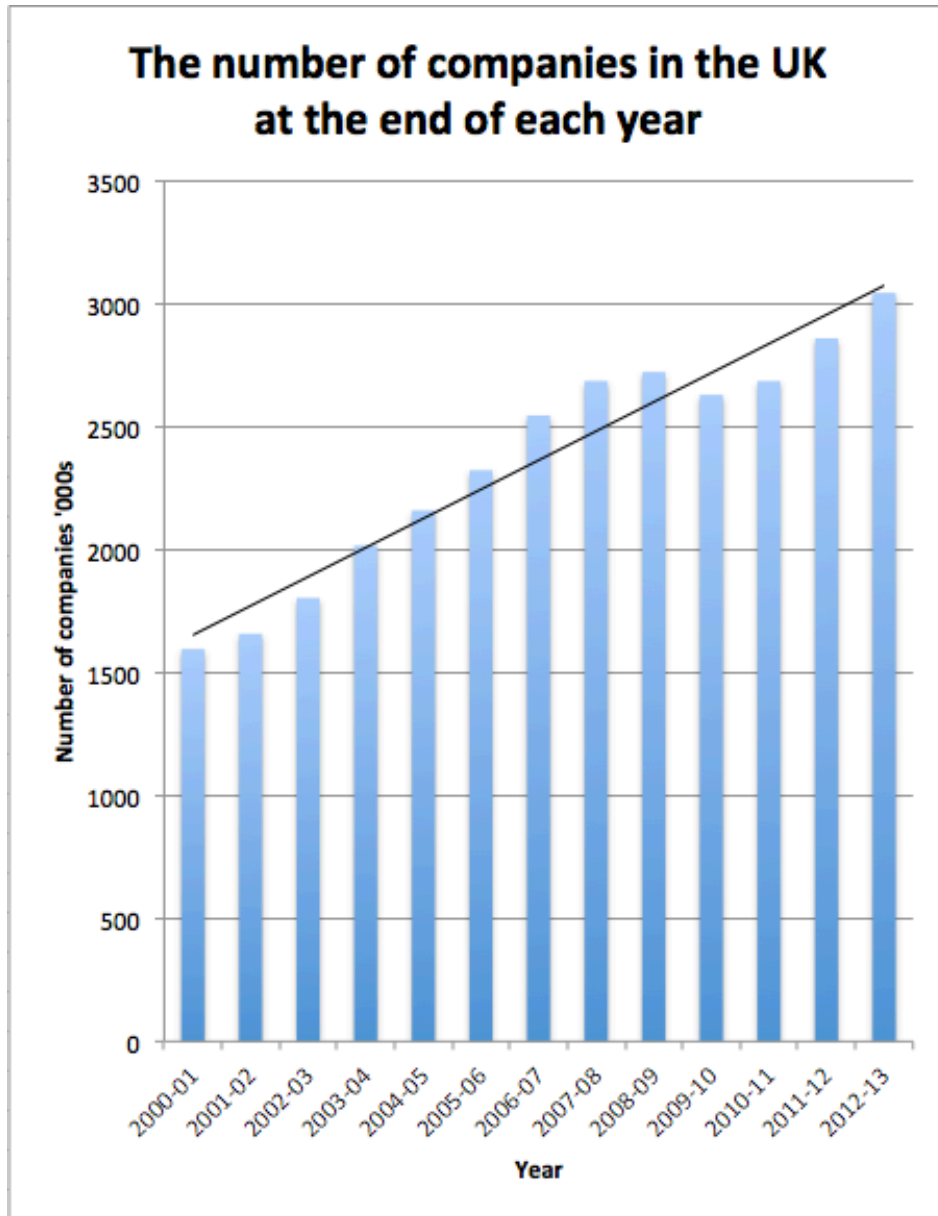
**Figure 3**

**Source: Companies House Annual Reports on Register Activity**

The exceptionally high number of companies dissolved in 2009-10 appears to be due to a policy decision made that year to cleanse the Register of Companies of many defunct companies. However, the rate has not fallen back to previous levels since then. As data noted later in this report suggests, it would seem likely that the Registrar of Companies is now not allowing companies to exist on the Register if they do not file documents with them that should be required by law. This means that many more companies are now being dissolved each year to prevent a backlog of the type dealt with in 2009. However, the

increased number of companies being routinely dissolved every year for simply failing to file documents with the Registrar of Companies without any further enquiry is a major cause for concern.

Figure 4 gives further context by showing the number of companies in the UK since 2000.



**Figure 4**

**Source: Companies House Annual Reports on Register Activity**

A trend line has been added for emphasis but the story is very clear. Despite the aberrational number of companies dissolved in 2009, the number of companies in existence in the UK has almost exactly doubled since 2000. Such growth warrants considerable regulatory attention which is currently not being given.

## b. Why do people form companies in the UK?

UK residents are likely to form companies for at least one of the following four reasons:

1. **They want to trade in this country but not in their own name.** That reason for not wishing to trade in their own name may be because a company has the advantage over an individual of having limited liability for its debts. This means that if it goes bankrupt and cannot pay those to whom it owes money its shareholders are not liable to pay these people. This means that there is a massive advantage to someone who wants to undertake a risky business when undertaking it through a limited company. They can invest as little as £1 in the share capital of the company and the entire risk of loss if it all goes wrong can be placed on others. Those others are the people who have traded with the company in good faith, despite which they lose if the company fails. Given the number of companies in the UK this does, in effect, means that much of the risk in limited companies is in fact underwritten by society at large. That is why we all have an interest in companies being well regulated.
2. **They want to be in trade with one or more other people.** A company protects a person from the activities their business partners undertake and provides a more secure way of regulating the relationship between them than a partnership often does.
3. **Some people have to trade through companies because the companies/individuals they want to trade with insist upon their using this structure.** The reasons for this will be noted below when tax is taken into consideration.
4. **Sometimes using a company structure helps a business grow.** Banks are usually more inclined to lend money to companies than individuals because the structure of a company can make it easier for them to recover their money if things go wrong (albeit at cost to other creditors of the company).

Those four reasons then, in broad outline, explain why people in the UK might form a company to undertake a trade. There are however other reasons for doing so in addition to these.

The first of these is that it is commonly thought that owning a company is a way of protecting the use of a name. In that case people form a company to suggest they have name, which they may also, for example, use for their website address. They may also do this because they think it is easier than registering a trademark. In these cases it can happen that a company can be formed without any intention to trade the company. However, since very few people want to protect a name unless they think there is profit in doing so this, it is suggested, is probably very much less likely than is commonly thought to be true.

More often the explanation for dormant companies is that people who have traded in the past retain an emotional attachment to their company that they formed for this purpose

and the name that they used. As a result they keep the company name and details on the register even after they have ceased trading to retain names just in case they want to use them again. In either case these are what are called 'dormant companies' i.e. companies that exist and which their owners wish to keep but which do not actually undertake any trading activity.

This then leaves consideration of the use made of UK resident companies by people who are themselves not resident in the UK. As is noted below, this is likely to be becoming more commonplace, although the precise numbers of companies involved is not known. There are four main reasons for people to form companies in the UK when they are not resident here:

- 1. The first is that UK companies are readily available, and quickly available.** Incorporation of a company is often being available on the same day that it is requested in the UK. This contrasts with the situation in many European countries where matters this takes a lot longer.<sup>vi</sup>
- 2. Secondly, UK companies cost much less than in Europe.** Companies are available for purchase for much less than £100 in the UK and the annual filing fee is just £13 if made online and the minimum capital of a UK company is just £1. The equivalent figures are much higher in most other European countries.<sup>vii</sup>
- 3. Setting up a company in the UK can hide the existence of a trade from a domestic tax authority in the company owner's home country.** It is very easy for non-UK resident owners to buy the services of UK nominee directors and shareholders who can hide the real ownership and management of a company. They can use a nominee registered office address to conceal the company's real place of trade.<sup>viii</sup> The services of nominee directors are also readily available for UK companies, many of whom are themselves located in tax havens so that the chance of them being held to account for what they do is very low. As such secrecy is readily available when using UK based companies.
- 4. The UK does not charge tax on profits arising outside the UK.** Recent changes in UK corporation tax laws mean that if a company does not trade in the UK then its profits arising outside the UK cannot be subject to UK corporation tax in most cases. It is therefore relatively easy for a non-UK resident to set up a UK company and be entirely unconnected with it on paper but have it trade in another country and make no declaration of its existence in that country or pay any tax there or in the UK. It cannot be proven that this practice is on the rise because of changes in the UK's tax system since 2010, but it is suspected that this practice is now becoming commonplace, not primarily because UK tax practice in this area is particularly unusual within Europe, but because the ease of incorporation in this country is definitely exceptional in the European context.

### **c. Why companies have become more popular since 2000**

The number of companies incorporated in the UK has increased significantly since 2000. There are three main explanations for this:

1. The audit requirement for the accounts of almost all but the very largest companies in the UK was abolished from 2004 onwards, ending a process of deregulation with regard to audit that had evolved quite rapidly over the previous decade or so;
2. The cost of incorporation of a limited company has steadily fallen in both absolute and relative terms during the course of this period;
3. Extraordinary tax incentives to incorporate the trade of a self-employed person through a limited company were offered from 2002 to 2006. While some of these were removed from 2006 onwards there remain considerable tax advantages to using a company for many small businesses.

Each of these issues is considered in further detail in Appendix 1.

#### **d. The obligations of a limited company**

The obligations of a UK based limited company fall in to two parts. The first is to keep the records of the company held by the Registrar of Companies at Companies House up to date. This issue is dealt with first in this section. The second obligation is to advise HMRC that it may be liable to corporation tax and to submit a tax return to HMRC if it is asked to do so. A summary of these tax obligations is supplied in the second part of this section.

- **Company law obligations**

It is remarkably easy to form a company in the UK. Incorporation is offered online for a price of as little as<sup>ix</sup> £13. Jason Sharman, an Australian academic who studies the practical comparative ease of incorporating companies around the world, has noted<sup>x</sup> that the regulatory standards associated with incorporation of a company in the UK are extraordinarily weak.

For example, it is possible to form a company entirely online<sup>xi</sup> without any identity checks being made or the physical signing of any documents being required.<sup>xii</sup> A formation agent is usually employed to act as an intermediary in this process who also has no obligation to identify their client or seek verification of their client's entitlement to the name or address they are registering for the purposes of incorporation.

Furthermore, the Registrar of Companies does not require anyone registering themselves as the owner of a share in a company to actually enjoy beneficial ownership of the share in question. Although it is required that a UK company lists those people recorded as owners of its shares, there is no proof required as to who benefits from the ownership of the company, making the disclosure required by law meaningless for all practical purposes. Changes in this law are currently being proposed but it is not clear how effective they will be.

The Registrar of Companies does not require anyone acting as a director or a UK company to prove their identity when registering themselves as director. The only significant check undertaken when forms recording such appointments are made is that the address shown matches with the declared postcode. Otherwise it seems that they are usually accepted without question.

It is therefore clear that a UK company can be formed by anyone using any identity and from any address. The problem of hiding the real whereabouts of a company can also be easily overcome since many Certificates of Incorporation are now issued as PDF files to any nominated email address and many company incorporation agents will, in any case, supply a company with an address for a nominal fee.

With just one shareholder and one officer (the sole director) being named, a company can be incorporated. It then has three recurring obligations to:

1. **File an annual return**, with the first due just over twelve months after incorporation. This return may be filed electronically with no proof of identity and a fee of just £13 being payable. If filed on paper and submitted by post the fee is £40. The annual return form requires that details of the directors, company secretary (if there is one), issued share capital, names of all shareholders and very limited information on the trade of the company (satisfied by making reference to a four digit trade classification code) be filed.
2. **Keep accounts.** These are usually for an annual period, although some exceptions are allowed. The accounts need not be audited if the company is considered to be small. The vast majority of companies (well over 90 per cent) now meet this criterion. Although the format of company accounts appears odd to a layperson it is now relatively easy to use proprietary software to turn self-produced accounting data into the format (or something approximating to it) required by UK company law. Since Companies House only check that the correct forms of wording with regard to declarations on the Director's Report and Balance Sheet are used, and that those reports have been signed and that the accounts do actually balance (i.e. the assets on the balance sheet equal the liabilities) the most extraordinary range of accounting errors can and do as a result go entirely undetected on submission of accounts to Companies House. Experience of making complaints about accounts submitted by companies suggests that the Registrar of Companies has remarkably little appetite for pursuing errors in such accounts, even when they are drawn to their attention. No fee is due to the Registrar of Companies when submitting accounts. They may be filed electronically. No fee is due when filing accounts.
3. **Notify of any changes** in the appointment of any officers of the company, or of its registered office. Again no proof of the validity of these changes is requested by the Registrar of Companies. No fee is due when submitting these forms. They may be filed electronically.

These obligations are not onerous and once initial contact with the Registrar has been made to establish entitlement to electronic filing of data almost no contact thereafter requires a physical address. This means that even the supposed physical location at which a company is located can remain, for all practical purposes, unverified by the Registrar of Companies. However, despite this apparent ease of keeping the affairs of a company in good order non-compliance is prevalent, as the next chapter of this report shows.

- **Why company law obligations exist**

Company law obligations exist because the owners of limited liability companies are granted a privilege by society. Companies are allowed to declare themselves bankrupt and the members of the company do not need to pay off the debts if that happens. They have 'limited liability' because they can only lose the amount of money they have invested in the share capital of company, which may be as little as £1. By contrast, if a partnership goes bankrupt its members have to pay its debts or they too could be personally bankrupted.

When permitting limited companies to be created, Parliament thought the right to not pay debts was an extraordinary privilege and made demands of companies to ensure that the privilege was not abused. Those demands still include the provision of details on the people owning and running the company so that anyone who wants to trade with it can assess their trustworthiness. Parliament also demanded that accounts be put on public record so that anyone trading with the company can see whether or not the company is sufficiently well funded to meet its likely debts. Today even those small companies that no longer have to publish a profit and loss account still have to publish a balance sheet as this is supposed to reveal the ability of a company to pay its debts.

Placing the records of a company on the public register at Companies House is, therefore, a matter of considerable importance if confidence is to be maintained in the credibility of the UK business community at large.

- **Tax obligations**

A company has at least three tax obligations. The first is to notify HMRC that it may be liable to corporation tax, and to then submit corporation tax returns annually with its accounts to show what tax is due on its profits if it is asked to do so. The second obligation is, like any business, to register for VAT if its chargeable sales for the purposes of that tax exceed £79,000 a year (2013-14 rate).<sup>xiii</sup> Finally a company, again like any employer, must deduct income tax and national insurance (i.e. PAYE) from any payments they make to their staff.

HMRC is automatically notified by Companies House when a company is formed and given details of its registered office. HMRC automatically sends out a form (called a CT41G) asking for information as to its trade, directors and other basic data within weeks of it being established. There is, however no penalty for not completing this form. The advantage of doing so for some companies is that the option of declaring that the company has no intention of trading is made available at this point. If the new directors state that it is not

their intention that the company trade then the company is usually automatically exempted from filing a corporation tax return for up to five years as a result. The company should, if it starts trading in this period, tell HMRC that it has done so.

Whether or not form CT41G is sent back to HMRC, and unless exemption from having to submit a corporation tax return is granted, HMRC sends the company a request that it submit a corporation tax return. This return is due 12 months after the end of the period to which it relates, although any tax is due nine months after that period end. Penalties are due for returns submitted late.

VAT returns from small companies are due every three months and just after the end of the period to which they relate. PAYE is now usually due monthly. Corporation tax returns involve a much less interactive process and the requirement is just for the return itself – as long as it is submitted little further enquiry is usually made.

- **Why tax obligations matter**

The tax obligations of companies matter for a simple reason, which is that society depends upon them. Corporation tax makes up about eight per cent of the total UK government tax income. All VAT is collected from VAT registered business and as will be noted later in this report the vast majority of these by value are limited companies. VAT comprises about 20 per cent of the UK total tax take. PAYE paid over by employers represents about 50 per cent of all UK taxes and most is paid over by companies.<sup>xiv</sup>

The result is that the UK tax system is quite critically dependent upon companies paying over the taxes that they owe to HMRC if we are to have a properly functioning tax system so that the government has the funding it requires to meet its obligations to the people of the UK.

### **3. Problems arising in the 21st century era of company regulation**

#### **a. Objectives for this chapter**

The previous chapter has:

- Explained the growth in the number of companies in the UK;
- Offered explanation for this growth in company numbers;
- Indicated that the obligations imposed on companies have in many ways reduced in recent years, especially with regard to accounts and auditing;
- Explained what those obligations of company are;
- Made clear why it is important to society that those obligations are fulfilled if tax is to be collected and confidence in business is to be maintained.

This chapter will:

- Explain which organisations are responsible for tracking the activities of the UK's companies;
- Discuss the impact of cuts on the effectiveness of the organisations tasked with regulating companies;
- Consider some of the rhetoric in current use regarding this issue;
- Suggest that an environment in which regulatory failure has become almost inevitable has been created.

#### **b. The organisations tasked with tracking UK company activity**

Four regulators monitor the activity of UK companies in different ways:

- Companies House, which is an executive agency of the Department for Business, Innovation and Skills. It is responsible maintain the Register of Companies;
- HMRC which is responsible for operating the UK's tax system;
- The Department for Business, Innovation and Skills, which maintains data on the scale of business activity in the UK;
- The Office for National Statistics, which records information on a wide range of issues, some of which relate to company activity.

Of these, Companies House and HMRC are by far the most important.

Companies House is responsible for registering new companies, recording and maintaining details of all UK companies and tracking down anyone failing to meet their obligations.

HMRC was created in 2005 in a result of a merger of the former Inland Revenue, which was responsible for income tax and corporation tax, and HM Customs & Excise, which was

responsible for VAT and various duties e.g. those due on sales of alcohol. It also acquired responsibility for national insurance; previously that was the responsibility of what was once called the Department for Social Security. The differences between the former departments are still apparent in quite large parts of HMRC work.

With relatively rare exceptions (for example, Companies House advising HM Revenue & Customs of the incorporation of a new company and of the proposed striking off of a company from its Register) there have been relatively few overlaps between the records of these departments. It also remains the case that not all records at HMRC are integrated internally, although matters are improving and proposals have been made to integrate the submission of annual accounts and corporation tax returns to the two authorities.

The Department for Business, Innovation and Skills tends to keep and publish records that are based on data sets produced by other organisations, including Companies House and HMRC.

### **c. The impact of cuts on HMRC and Companies House**

As a result of government cuts both HMRC and Companies House have been facing the challenge of considerable staffing cuts in their staffing. The result is that many feel that these organisations are now short staffed for the critical job of checking the data that they receive.

For example, Companies House accounts<sup>xv</sup> indicate that from 2008 to 2011 its staff numbers varied little from an average of about 1075 staff. However staff levels fell to 957 in 2012 and 890 in 2013 as part of a plan announced in 2011 to reduce staff by 250. This suggests further cuts are likely in the current year.<sup>xvi</sup>

The staff cuts at HMRC have been even more dramatic from 99,309 staff in 2005<sup>xvii</sup> to 68,520 in 2013.<sup>xviii</sup> Further job cuts, expected to exceed more than 15,000 posts in total, are still planned. It is likely that the department's workforce will approximately halve in little over a decade.

It has to be said that many jobs have been cut because of users supplying data online with no additional processing now needed by HMRC. However, these cuts have also been motivated by the general desire to cut costs across the civil service and in government agencies.

The impact of these cuts has been haphazard, at best. For example, Companies House says in its 2012/13 accounts:<sup>xix</sup>

*Savings totaling £2.2m were made during the year including procurement savings from amongst others, improved prices on contract renewals, increasing the number*

*of electronic reminder letters sent to customers, and achieving significant staff cost savings by not routinely backfilling vacancies as they arose.*

The difficulty with the 'electronic reminders' mentioned here is that they look exactly like instructions that can be ignored by most recipients.

Failing to fill posts as they become vacant does also not appear to be a systematic approach to staff reduction. While saving money in the short term, these cuts may end up costing the economy a great deal.

#### **d. The rhetoric of 'cutting red tape'**

Coupled with staffing cuts has been an ongoing rhetoric from politicians over the past decade that government regulation is 'red tape' and burdensome for business. This sentiment motivated many of the relaxations in the requirement for accounts to be audited before submission to Companies House. The latest relaxation with regard to this requirement was announced in January 2014 as part of the government's 'red tape challenge'.<sup>xx</sup> Ministers offer no suggestion on these occasions that auditing and other company obligations may have been created to protect society at large from abuse; it appears to be assumed instead that all such regulation is burdensome and that it should be removed wherever possible.

The likely impact of a continual diet of such commentary, which has now been commonplace for more than a decade, is that business itself sees its responsibility to file documentation with regulatory authorities as burdensome and potentially unnecessary because that is what many of the politicians responsible for those bodies suggest it to be. As the Prime Minister is reported to have when this latest announcement on auditing was made:<sup>xxi</sup>

*Mr Cameron said he wanted to "get out of the way of small business success." Reducing red tape, cutting business rates, and scrapping the jobs tax from April 2015 were ways the government was supporting small businesses, said Mr Cameron.*

The implication is that submitting data to HMRC and Companies House may get in the way of business success. The result is the creation of the shadow company – which does not, as a matter of fact, undertake burdensome activities like filing accounts or annual returns or paying its tax.

## 4. Shadow companies – the data

### a. Objectives for this chapter

The previous chapter has:

- Explained the falling resources available to check the regulatory and tax filings of a growing number of companies;
- The creation of a culture where the regular filing of documents as required by law is seen as being a burden on small business;
- Introduced the idea of the ‘shadow company’ where neither the directors or owners feel they have a responsibility for ensuring that the company fulfills its obligations to Companies House or HM Revenue & Customs.

This chapter will:

- Explore data on the number of accounts and annual returns not submitted to Companies House each year;
- Explain why Companies House statistics on this issue are misleading;
- Consider how many corporation tax returns might be requested by HM Revenue & Customs each year, how many are actually requested and how many are actually submitted;
- Seek to explain why HMRC does not always request corporation tax returns;
- Look at data on how many companies corporation tax data suggests are trading in the UK, and how many of them pay tax;
- Consider how many of the corporation tax returns are investigated by HM Revenue & Customs;
- Suggest how many corporation tax returns are not made.

The result is that this chapter is dedicated to considering quite a lot of data.

### b. Companies House data on companies being removed from the Register

The idea of the ‘shadow company’ for which the owners and directors appear to think they have little responsibility seems to be a feature of 21<sup>st</sup> century company regulation. The analysis in this chapter seeks evidence to suggest that this phenomenon exists.

The data used for this purpose has usually been restricted to the years ending 31 March 2006 onwards as this is usually sufficient to develop the arguments made here. This period began before the economic recession that started in 2008 got underway and continues through that period of economic change.

Figure 5 shows the number of companies registered at Companies House during this period, using data extracted from their annual reports on Company Register activity (including some inconsistencies from year to year in their own reports).

Companies House Data	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands
On register at start of period	2160.2	2323.1	2546.2	2686.5	2769.7	2629.9	2686.2	2859.7
New companies incorporated	372	449.7	372.4	330.1	365.6	400.6	455.6	482.8
Dissolved	212.1	225.4	233.8	330.5	509.7	348.4	287.8	302.6
Restored	1.4	1.4	1.8	2.1	4.3	4.9	5.6	4.9
On register at end of period	2323.1	2546.2	2686.5	2722.7	2629.9	2686.2	2859.7	3044.7
Of which in liquidation	66.9	66.5	68.8	69.6	76.4	74.4	78.6	80.4
Of which in course of removal	126	138.2	194.5	383.1	194.4	156.4	168.4	185.9
Effective number on register at end of period	2130.2	2341.5	2423.2	2270.0	2359.1	2455.4	2612.6	2778.4

**Figure 5**

**Source: Companies House Annual Reports on Register Activity**

The underlying trend in this data has been shown in the graphs in chapter 2.

It is important to note that Companies House consider they manage an ‘effective number of companies’ on the register when they report. They ignore companies in the course of removal when preparing their own management data on the register they maintain. For this reason it is important to note that companies are dissolved in two ways.

Firstly companies can be dissolved through a formal liquidation, which can either be instigated by the members of a company if it is solvent, or by the creditors (often HM Revenue & Customs) if it is insolvent. In either case the process is regulated; a regulated liquidator is appointed, full accounts have to be prepared and reports filed. The process can take some time: it is highly likely that a reasonable number of companies included in those being removed from the register by way of liquidation at one year end will be in the same category at the following year end. Companies in liquidation are subject to a requirement that they furnish Companies House and HM Revenue & Customs with information on their activities during the period of their liquidation.

Secondly, companies can be ‘struck off’ the Register. Figure 6 shows the number of companies removed from the register each year, and the way in which they were removed, from 2005/06 onwards.

Breakdown of the number of companies dissolved:	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands
Struck off	194.5	206.8	216.0	300.5	486.8	324.4	267.3	280.5
Liquidated	17.6	18.7	17.9	30	21.8	24.1	20.5	22.1
Total removed	212.1	225.5	233.9	330.5	509.7	348.5	287.8	302.6

**Figure 6**

**Source: Companies House Annual Reports on Register Activity**

Striking a company off the Register is quite different from a company being liquidated. As Companies House says on its web site, if a person wants a company struck off the register, which process means that they no longer have to file annual returns or accounts, they should do the following.<sup>xxii</sup>

Complete and send us Form DS01 with a £10 filing fee: The Registrar will provide the form on request. However, striking-off is only applicable to a company if, in the past three months, it has not:

- traded or otherwise carried on business;
- changed its name;
- disposed for value of property or rights that, immediately before ceasing to be in business or trade, it held for disposal or gain in the normal course of that business or trade; or
- engaged in any other activity except one necessary or expedient for making a striking-off application, settling the company's affairs or meeting a statutory requirement. A company can, however, apply if it has settled trading or business debts in the previous three months.

This is an extraordinary admission by Companies House. What it does, in effect say, is that anyone who has had a company that has traded, and even operated a bank account in the last three months, can apply to have their company struck from the Register of Companies and. They do not have to file their accounts for the period in question or file an annual return form with Companies House. In effect, for £10 anyone can have a 'get out of regulation' pass and avoid all their obligations with regard to a company they have formed, even if it has traded.

The striking off process can be started by Companies House as well as by the company itself. This happens when a company either fails to file its accounts or annual return form on time. It appears that Companies House has been much more rigorous in having companies removed from the Register for this reason from 2009/10 onwards<sup>xxiii</sup>. The shift in policy that appeared to occur at that time from potentially prosecuting for failure file documents to striking off errant companies instead poses a question about balance in this process and whether Companies House should be striking off companies that fail to register documents due to be filed by law, To do so in many cases is at a cost to society at large. Figure 7 shows the very low current prosecution rates.

Companies House prosecutions	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Failure to deliver accounts	5251	4084	3733	2089	2879	3440	4123	3816
Convictions	2902	2418	1600	1068	1397	1687	2051	1833
Conviction rate	55.3%	59.2%	42.9%	51.1%	48.5%	49.0%	49.7%	48.0%
Failure to deliver an annual return	2256	2499	1991	1461	1728	1703	2127	1846
Convictions	1194	1516	927	802	925	892	1121	934
Conviction rate	52.9%	60.7%	46.6%	54.9%	53.5%	52.4%	52.7%	50.6%

**Figure 7**

**Source: Companies House Annual Reports on Register Activity**

The low prosecution rate occurs because if a document is filed once an action has begun the prosecution is usually abandoned. This wastes time and effort, not least because the failure has still occurred since filing late is still an offence. In Scotland there have been no prosecutions at all by Companies House<sup>xxiv</sup> since at least 2008/09.<sup>xxv</sup>

### c. The number of companies failing to file annual return forms with Companies House

In the shade: the UK's missing economy

Every company is obliged to file an annual return form with Companies House shortly after its anniversary of incorporation. In principle, therefore, almost every company on the Register of Companies at the start of a year has an obligation to file an annual return form during the year that follows. However, there is ample evidence that this does not happen, as Figure 8 shows.

<b>Number of annual returns filed with Companies House</b>	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Average
	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands	Thousands
Number of annual returns filed with Companies House	1758	1866	1929	2106	2128	2157	2263	2387	2074
Number of companies on register at year end	2323	2546	2687	2723	2630	2686	2860	3045	2687
Effective number on register	2130	2342	2423	2270	2359	2455	2613	2778	2421
Number of companies on register at start of the year	2160	2323	2546	2687	2770	2630	2686	2860	2583
% of companies on register at start of the year filing annual return	81.4%	80.3%	75.8%	78.4%	76.8%	82.0%	84.2%	83.5%	80.3%
Number of companies in year not filing annual return									
<b>Based on number at start of the year</b>	<b>402</b>	<b>457</b>	<b>617</b>	<b>581</b>	<b>642</b>	<b>473</b>	<b>423</b>	<b>473</b>	<b>508</b>
Less, number being dissolved at start of year	180	193	205	263	453	271	231	247	255
Net not filing	222	264	413	317	189	202	192	226	253

**Figure 8**

**Source: Companies House Annual Reports on Register Activity**

The critical line is highlighted in bold - an average of 508,000 companies a year did not file annual return forms over this period. Much of this failure is explained by the fact that the missing returns should have been filed by companies that were dissolved during the period when the return was due. However, the key point is that during this eight year period, the striking off process allowed an average of 19.7 per cent of all companies to not file the annual return forms that provide legally required information on their ownership and control.

It is important to note in this respect how many of these companies were struck off as a result of action by Companies House and how many by the companies themselves. This is not data that Companies House reports but parliamentary questions have given insight into the issue. As noted above, of the 509,700 companies struck off in 2009/10, some 335,475 were as a result of Companies House action. That is a rate of almost 66 per cent. Since then a parliamentary question by Caroline Lucas MP has revealed more data on this issue.<sup>xxvi</sup> Figure 9 shows data on the number of companies being struck off each year as a result of action by Companies House.

<i>Ending 31 March each year</i>	<i>Number struck off as a result of action by Regsitar of Companies</i>	<i>Total struck off in year</i>	<i>% struck off by Registrar action</i>
2007	89,153	206,800	43.1%
2008	93,026	216,000	43.1%
2009	92,578	300,500	30.8%
2010	317,660	486,800	65.3%
2011	181,172	324,400	55.8%
2012	129,952	267,300	48.6%
2013	131,481	280,500	46.9%

**Figure 9**

**Source: Parliamentary answer to Caroline Lucas MP from Rt Hon Michael Fallon MP  
14 January 2014 number 182426**

While the year to 31 March 2010 was an exceptional year, it is still true that 50 per cent of all 'striking off' are now taken by the Registrar.

Objections can be made against such striking off. Figure 10, for example, provides relevant data on such objections, all based on recent parliamentary questions by Caroline Lucas MP.

<i>Ending 31 March each year</i>	<i>Number struck off as a result of action by Regsitar of Companies</i>	<i>Total struck off in year</i>	<i>% struck off by Registrar action</i>	<i>Number of objections to striking off lodged</i>	<i>Proprtion subject to objection</i>	<i>Number of objections from HMRC</i>	<i>Proprtion of all objections coming from HMRC</i>
2007	89,153	206,800	43.1%	7,283	3.5%		
2008	93,026	216,000	43.1%	12,576	5.8%		
2009	92,578	300,500	30.8%	76,300	25.4%		
2010	317,660	486,800	65.3%	83,720	17.2%		
2011	181,172	324,400	55.8%	116,868	36.0%	111,136	95.1%
2012	129,952	267,300	48.6%	136,239	51.0%	121,711	89.3%
2013	131,481	280,500	46.9%	n/a			

**Figure 10**

**Source: Parliamentary answer to Caroline Lucas MP from Rt Hon Michael Fallon MP  
14 January 2014 number 182414**

It appears that HMRC also changed its policy on striking off in 2009. Although data from before 2011 on the number of striking off to which HMRC objected appears unreliable, it is apparent that before 2008 they objected rarely, and since then the numbers have risen significantly. This is welcome; however anecdotal advice from Companies House suggests that the deferral period on a first objection is just three months and the increased number of objections actually reflects some multiple objections from HMRC intended to secure a second (and maybe further) deferral period. According to the same anecdotal source these second deferrals are, however, much rarer than first applications for deferral of striking off. It therefore follows that the vast majority of objections appear to occur after HMRC is satisfied that the prospect of their being paid is limited without, in all likelihood, many missing corporation tax, PAYE or VAT returns being secured. While it is positive that HMRC is now raising objections to striking off, the failure to apparently secure much benefit from doing so highlights the changes required in law to let them recover missing tax.

**d. The number of companies failing to file annual accounts with Companies House**

In the case of annual accounts due to be filed with the Registrar of Companies the time delay with regard to the filing requirement arising is longer than for annual returns since a company's first accounts are not due to be filed with Companies House until 21 months

after a company is incorporated. As a result it is not the total number of companies on the register at the start of the year that might file accounts during the following year, but that number of companies minus those formed in the nine months before the start of that year that need to file. Figure 11 takes this into account where the number of companies likely to be less than nine months old at the start of the year is 75% of all companies in aggregate formed in the previous year, which is the best available approximation.

Number of accounts filed with Companies House by type	2005-06 Thousands	2006-07 Thousands	2007-08 Thousands	2008-09 Thousands	2009-10 Thousands	2010-11 Thousands	2011-12 Thousands	2012-13 Thousands	Average Thousands
Full	144	138	144	143	157	131	120	124	136
Abbreviated small	64	57	56	56	58	56	54	54	56
Abbreviated medium	8	7	8	9	9	6	5	5	7
Group	16	15	15	15	17	19	19	20	18
Dormant	299	309	336	362	371	374	392	406	373
Interim	0	0	1	0	0	0	0	0	0
Audit exempt	1043	1124	1250	1333	1409	1430	1470	1568	1410
<b>Total number of accounts filed</b>	<b>1574</b>	<b>1651</b>	<b>1809</b>	<b>1918</b>	<b>2021</b>	<b>2016</b>	<b>2061</b>	<b>2176</b>	<b>2000</b>
Number of companies on register at start of year	2160	2323	2546	2687	2770	2630	2686	2860	2696
Number of companies likely to be less than 9 months old on Register at start of year	250	279	337	279	248	274	300	342	297
<b>Net number of companies likely to be due to file accounts in year</b>	<b>1910</b>	<b>2044</b>	<b>2209</b>	<b>2407</b>	<b>2522</b>	<b>2356</b>	<b>2386</b>	<b>2518</b>	<b>2400</b>
% of companies required to file accounts actually doing so	82.4%	80.8%	81.9%	79.7%	80.1%	85.6%	86.4%	86.4%	83.3%
Number of companies in year not filing accounts									
Based on net number of companies due to file accounts at start of year	336	393	400	489	502	340	325	342	400
Less, number being dissolved at start of year	180	193	205	263	453	271	231	247	278
Net non-filing	156	200	195	226	49	69	94	95	121

**Figure 11**

**Source: Companies House Annual Reports on Register Activity**

Figure 11 shows the number of companies filing accounts of differing types in the year to produce a total number of accounts filed. It then compares this total with the number of companies likely to be liable to file accounts in the year. On average only 83.3 per cent of all expected sets of accounts are filed and on average 400,000 sets of accounts a year have not been filed.

This can be adjusted since some companies were being dissolved at the start of the year and therefore would not file accounts but it also ignores the fact that many of those struck off may have been due to file accounts since a company can be struck off within three months of it ceasing to trade and without filing any accounts when doing so. The true figure for accounts not filed is therefore the higher one. That is, an average of 400,000 sets of accounts per year that are not sent to the Registrar of Companies by companies who may well have traded. Many of these will, of course, be due by companies among the 508,000 a year on average who do not file an annual return form.

#### **e. Companies House statistics on these issues**

These statistics appear to be in marked contrast to data published by Companies House in its annual reports on register activity. According to its latest such annual report<sup>xxvii</sup> 98 per cent of all annual returns and 99.1 per cent of all accounts were filed on time in 2012/13. However, these figures are calculated on what the Registrar calls the 'effective register', which represents the total number of companies in existence less those in the process of being removed. However, since that process of removal cancels the need for an annual return and accounts or is in fact initiated by the Registrar because an annual return or

accounts has not been filed, this is a the net effect is to massively understatement of the percentage of accounts and annual returns not filed.

The true data for 2012/13 is that 16.5 per cent of annual returns were not filed and 13.6 per cent of accounts were not filed whilst over a more extended period these figures were 19.7% and 16.3% respectively. Most importantly, it is likely that 342,000 sets of accounts were not filed in 2012/13, meaning that data on these companies' trading was never given the publicity required by law.

#### f. Corporation tax return filing data

HMRC needs companies' accounts as well as Companies House. For that reason data on tax returns filed by companies has been investigated, assisted by information put into the public domain by a series of parliamentary questions asked by Caroline Lucas MP who has taken a long term interest in this issue.<sup>xxviii</sup>

Figure 12 shows how many companies are asked for their details by HMRC via the CT41G form.. Strangely, it indicates that HMRC actually seems to ask more companies for information than the number of companies that are formed in most years:

	Number of forms CT41 G sent by HM Revenue and Customs in the year	Number of companies incorporated in year	Difference	% of new companies form whom data is requested
2007-08	436,179	372,400	63,779	117.1%
2008-09	333,224	330,100	3,124	100.9%
2009-10	353,097	365,600	-12,503	96.6%
2010-11	447,530	400,600	46,930	111.7%
2011-12	474,335	455,600	18,735	104.1%
2012-13	509,533	482,800	26,733	105.5%

**Figure 12**

Differences may, of course, be due to lags in notification to HMRC after incorporation but generally this process seems to work. Unfortunately the process is undertaken to seemingly little avail. HM Treasury has advised:<sup>xxix</sup>

*HMRC does not count the number of CT41Gs returned. Companies supply the required information in a variety of ways, not always using the form. There is now an online registration service that companies can use.*

This suggests that from the outset there appears to be no monitoring of which companies are trading or not and which are liable to submit a corporation tax return. This situation is not helped by the fact that the information requested from companies on form CT41G can also be filed online without cross reference between the on and off-line processes.

Despite this it is clear that HMRC decides that some companies do not need to file corporation tax returns based on CT41G data. The most common explanation is that the companies in question are said, on the basis of self-declaration, to be dormant. As HMRC says on its web site:<sup>xxx</sup>

*If your company stops trading or is not active, you need to tell your Corporation Tax Office, as soon as possible, in writing, that your company is dormant. HMRC will send your company a 'Notice to deliver a Company Tax Return' for the period up to the date your company became dormant. From the date your company becomes dormant, HMRC will stop treating your company as active and you won't receive unnecessary correspondence.*

While it is not yet known how many companies HMRC thinks to be dormant and which are not, as a result, sent 'unnecessary correspondence' in the form an annual corporation tax return, some clues are available. First, Companies House allows companies to file what are called 'dormant company accounts'. A dormant company is defined by the Registrar of Companies as:<sup>xxxi</sup>

*"A company [that] has had no 'significant accounting transactions' during the accounting period. A 'significant accounting transaction' is one which the company should enter in its accounting records. The amount paid for shares on the formation of a company and a few costs that the company may incur in order to keep the company registered at Companies House do not count as significant accounting transactions."*

As Companies House also says:<sup>xxxii</sup>

*Companies may be dormant for various reasons, for example, to protect a company name, in readiness for a future project, or to hold an asset or intellectual property. Some flat management companies whose main purpose is to own the head lease or the freehold of a property choose to become dormant by setting up a residents' association to deal with any expenses.*

Another very good reason for having a dormant company could be that dormant companies can use the form in Figure 13. Accounts can be submitted via this form which can be downloaded from the Registrar's own web site and returned in an action requiring almost no effort at all.

This information can be filed securely and accurately online using WebFiling. This downloadable form, however, contains no built checks and must be printed, signed and posted to Companies House for manual processing.



**DCA**

**For a company limited by shares which is not a subsidiary and where the only transaction is the issue of subscriber shares**

CHWP000

Company Number

Company Name in full

Balance Sheet as at

	Current Year	Previous Year
Called up Share Capital not paid	£ <input type="text"/>	<input type="text"/>
Cash at Bank and in Hand	£ <input type="text"/>	<input type="text"/>
<b>NET ASSETS</b>	<b>£ <input type="text"/></b>	<b>£ <input type="text"/></b>
<i>Authorised share capital:</i>		
<input type="text"/> ordinary shares of £ <input type="text"/> each		
<i>Issued share capital:</i>		
<input type="text"/> ordinary shares of £ <input type="text"/> each	<input type="text"/>	<input type="text"/>
<b>SHAREHOLDERS' FUNDS</b>	<b>£ <input type="text"/></b>	<b>£ <input type="text"/></b>

**Notes:**

- During the year the company allotted ..... ordinary shares with an aggregate nominal value of £....., the consideration received by the company was £.....
- During the year the company acted as an agent for a person - **if this applies please tick the box**

**Statements:**

- For the year ended .....(date) the company was entitled to exemption under section 249AA(1) of the Companies Act 1985.
- Members have not required the company to obtain an audit in accordance with section 249B(2) of the Companies Act 1985.
- The director(s) acknowledge(s) responsibility for:
  - ensuring the company keeps accounting records which comply with section 221, and
  - preparing accounts which give a true and fair view of the state of affairs of the company as at the end of the financial year, and of its profit and loss for the financial year, in accordance with the requirements of section 226, and which otherwise comply with the requirements of the Companies Act relating to accounts, so far as applicable to the company.

These accounts were approved by the Board of Directors

on ..... ,  
and signed on their behalf by:  
Director(s)

You do not have to give any contact information in the box below but if you do, it will help Companies House to contact you if there is a query on the form. The contact information that you give will be visible to searchers of the public record.

Contact details:

03/2006

**Figure 13**

As is readily apparent, and as the one page of notes attached to the form also make clear, completing this document this is not an onerous task. It is simply a case of filling in the blanks and making sure that the net assets equal the shareholder's funds, following which

filing can take place.<sup>xxxiii</sup> There is no other set of accounts that can meet regulatory requirements and yet be so easily completed, and with no significant check whatsoever being in operation that the information filed bears any relationship at all with the actual position of the company.

406,000 companies used this form to submit accounts Companies House in 2012/13, making it the second most common form of accounts submitted. It is, of course, quite possible that many of these companies had also told HMRC that they were dormant and so did not have to submit corporation tax returns. Many of these declarations may well be true, but the fact remains that there is almost no checking of these accounts and HMRC does not even ask to see them. There is, therefore, a strong possibility that significant fraud and tax loss could result from this almost total absence of regulation.

That such fraud happens has been proved by NGO Global Witness<sup>xxxiv</sup>. As they noted in a 2012 report:

*In just two and a half years it appears that a staggering \$1.2bn passed through the Asia Universal Bank accounts of just three UK-registered companies, yet they never filed any account information at all before dissolving.*

*Two further UK companies appear to have had millions going through their AUB accounts while declaring to the UK's corporate registry that they were dormant, a breach of the Companies Act.*

That dormant company status can be abused is obvious as a result.

The following is an exchange from a hearing of the Public Accounts Committee of the House of Commons who in a hearing on 28 October 2013 addressed this issue:<sup>xxxv</sup>

**Chair [Margaret Hodge MP]:** *May I ask you something else? In 2009, which is the last year for which I have figures, 30 per cent of companies on the register-838,370 companies, to be precise-were not asked for a tax return; they did not provide a tax return to HMRC. How many did not provide a tax return to HMRC in 2011-12?*

**Edward Troup:** *Active companies or all companies on the register, because there are obviously quite a lot of dormant companies on the register?*

**Q236 Chair:** *All companies. I accept that there are dormant companies. It is just that 30 per cent is a heck of large figure. Dormant companies might-you tell me-be about 8 per cent or 10 per cent, if we are lucky.*

**Edward Troup:** *I do not have those figures.*

**Q237 Chair:** *Do you know, Mr Harra?*

**Jim Harra:** *I don't have the figure for that next year. I suspect that, in percentage terms, it is not materially different from the previous year.*

**Q238 Chair:** *Why was that?*

**Jim Harra:** *The main reason why we do not seek tax returns from all companies is because a significant number of them are either dormant, or registered in the UK but are not within the UK charge to corporation tax, because they are in fact operating outside the UK.*

**Q239 Chair:** What is your system of checks?

**Jim Harra:** First, we have a risk-based check. We send out a form called CT41G to every company, asking them for information about whether they are active. For those that say that they are not active, we then have a rolling programme of checks over a period on their dormancy.

**Q240 Chair:** I know that this is a 2009 figure. Can you give me the 2011-12 figure?

**Jim Harra:** I cannot offhand, I am afraid.

**Chair:** Can any of you? You are here talking about the 2011-12 accounts.

**Jim Harra:** I am afraid I cannot give you that figure. It will not be materially different, but I can certainly write to you afterwards with that figure.

**Q241 Chair:** Let us assume that there are about 800,000 to 900,000 companies. They are not all dormant, are they? Do you check all those 900,000?

**Jim Harra:** Over five years, on a rolling basis, we review the dormancy of companies.

**Q242 Chair:** Every company?

**Jim Harra:** Every company that we register as dormant, we review periodically over a period of time.

**Q243 Chair:** But dormant isn't the lot?

**Jim Harra:** The two main categories are either because they are dormant-company registration agencies set up shelf companies and keep them on the shelf, ready to sell to clients-or, increasingly, because the charges to register a company in the UK are low. We find that, for example, a lot of German businesses register on the UK register, but they operate only in Germany, so they are not within the charge to UK tax. Those would be the two main reasons.

**Q244 Chair:** And you can tell this Committee that of those 838,370 companies in 2009-a similar figure possibly today-all of those would have been checked? Or do you do a risk-based assessment, meaning that you will check a sample?

**Jim Harra:** Our process is to review dormancy on a periodic basis. Our experience is that the risk in that population is low.

**Q245 Ian Swales:** Can I ask for clarification on something that Jim has just said? Why would a German company take the time to register in this country? Just because it is low-cost would not make me go and register a company in a country I was not interested in.

**Jim Harra:** It has been our experience. I mentioned Germany in particular because it has been our experience that German businesses will register in the UK, because the charges for doing so are much lower than in Germany. Under EU law, they are entitled to establish wherever they wish.

**Chair:** What's the purpose?

**Q246 Ian Swales:** Why would they do that? Is that to avoid tax in Germany?

**Jim Harra:** No. It is to save them the registration cost.

**Q247 Mr Bacon:** So you mean that they trade in Germany, and their customer base is German-or perhaps they export and their customer base is overseas-but they do so as a UK-registered company?

**Jim Harra:** They will be on the UK register of companies.

**Q248 Mr Bacon:** But so long as none of the activity takes place in the UK, they don't attract any liability for tax in the UK.

**Jim Harra:** That's correct.

**Q249 Justin Tomlinson:** What is the difference in the fees?

**Jim Harra:** I do not know offhand. This is one of the things that we looked into. The number of companies that were not active in the UK was growing, and one of the reasons was because

we were seeing an increasing number of companies from elsewhere in the EU choosing to use the UK register.

**Q250 Ian Swales:** A final question. The cost of registering a company in different countries might vary, but it is not a huge cost of running a business. It is probably beyond the scope of today, but you seem to be suggesting that the UK has some regime-not just the cost of registration, but some other advantage-that would make companies register here. I cannot believe that it is simply to pay £200 rather than £800 or something. What else is going on?

**Jim Harra:** You are slightly talking to the wrong person, because it is not about tax, but about company registration and the behaviour. We have looked into it to get an understanding of why we were seeing the registration behaviour that we were. I can certainly pick up afterwards with you and write to you and explain that.

**Ian Swales:** The only relevance is that one of the Committee's concerns is this sort of tourism around the EU that seems to be going on, where you set up companies, invoicing points and so on, and one way or another you are extracting advantage from that. That just might be another example of that.

What is apparent is that the CT41G, which is not apparently monitored, is seen as part of this process of checking and that a five year cycle of checks is considered appropriate once a company is considered dormant despite the fact that the average age of a company on the Register of Companies in 2013 was just 8.8 years<sup>xxxvi</sup>.

As importantly, this was the first occasion on which HM Revenue & Customs had admitted that because of a change in UK law since 2010 that now means that no income arising to a company from outside the UK can be subject to UK tax HMRC is now beginning to not ask companies who say that this is their sole source of income for a UK tax return. Since no other explanations were offered by HMRC for not asking for a return it is assumed that these two explanations are complete between them.

It is important to recall when considering statistics on this issue that corporation tax returns should be requested from companies at about the same time as they are asked to make an annual return submission to Companies House, i.e. in the month following their anniversary of incorporation. Therefore the adjustment to data required when considering accounting issues and the number of companies on the register is not required in this case.

Figure 14 compares the number of companies that might be required to submit corporation tax returns and those who received a request for one.

Tax year	Number of companies sent a corporation tax return	Number of companies on register	Number of companies apparently not sent a corporation tax return	Proportion from whom tax returns requested	Effective number of companies at start of year + number in liquidation	Number of effective companies apparently not sent a corporation tax return	Proportion of effective companies on register from whom tax returns requested	Number of dormant companies based on those filing dormant company accounts	Remaining unexplained	Number of potential dormant companies - 18.7%	Number remaining unexplained in that case
2007-08	1,925,000	2,546,200	621,200	75.6%	2,408,000	483,000	79.9%	299,200	183,800	476,139	6,861
2008-09	1,961,000	2,686,500	725,500	73.0%	2,492,000	531,000	78.7%	309,200	221,800	502,376	28,625
2009-10	1,931,000	2,769,700	838,700	69.7%	2,339,600	408,600	82.5%	335,600	73,000	517,934	-109,334
2010-11	1,887,000	2,629,900	742,900	71.8%	2,435,500	548,500	77.5%	361,700	186,800	491,791	56,709
2011-12	1,880,000	2,686,200	806,200	70.0%	2,529,800	649,800	74.3%	371,000	278,800	502,319	147,481
Average of above	1,916,800	2,663,700	746,900	72.0%	2,440,980	524,180	78.6%	374,300	149,880	534,764	-10,584
2012-13	1,916,000	2,859,700	943,700	67.0%	2,691,300	775,300	71.2%	335,340	439,960	498,112	277,188

**Figure 14**

## **Sources: Parliamentary answers, Companies House data and author calculations**

Data for 2012-13 was likely to be incomplete at the time the above data was supplied and so is shown after an average has been computed. It has not been considered when extrapolating data or drawing conclusions.

As is clear, there are more companies not asked for corporation tax returns than are filing dormant company accounts. However, an odd fact that has been noted from the Companies House data, is that the number of companies claiming to be dormant by filing such accounts has been remarkably stable over time and. Might this ratio, therefore, indicate the proportion of the whole sample of all companies who are actually dormant, always accepting that some dormant companies will choose not to file their accounts on the form available for that purpose? If that relatively fixed ratio of companies filing dormant company accounts (between 18 and 19 per cent of the total sample filing accounts) is applied to the sample of all companies who might file it does, as the above table notes, in earlier years, appear to explain in very large part why corporation tax returns are not being requested (except in the aberrational year of 2009-10 where Companies House, of its own volition, massively increased the number of companies struck off the register, many of whom might have already been sent a corporation tax return request.

This pattern appears to change after 2010 with the number of unexplained returns then rising. A possible explanation for this could be the number of companies with foreign income now being granted exemption from filing a corporation tax return in the UK even though they trade, albeit elsewhere; a trend noted previously but for which no data is available.

If this trend of UK companies only trading elsewhere is growing rapidly, as is implied, it is, however, worrying for two reasons. First of all that is because failing to collect tax returns from these companies means that the UK is not collecting tax data that it may need to supply to other tax authorities under new information exchange agreements. Secondly, if this excuse for not filing returns becomes well known it is clearly open to considerable abuse from those tempted to commit fraud. As it is over 20 per cent of all companies incorporated in the UK are now routinely not asked to submit corporation tax returns with there being very few apparent checks in place to make sure that this is an appropriate action to take. It would be worrying if this ratio were to increase, as seems possible.

### **g. How many of the corporation tax returns requested are submitted?**

Figure 15 summarises information secured from parliamentary answers on the number of corporation tax returns requested, those that were submitted on time or late and various resulting calculations that then follow from this data (note that 2012-13 may not be complete and so is shown after averages are calculated).

Tax year	Number of tax returns requested	Number of companies submitting a return on time	Number submitting a return after the close of the time limit for doing so	Total corporation tax returns submitted	Proportion of returns submitted on time	Total proportion of those requested submitting a return	Proportion of companies on the register at start of the year submitting a return	Number requested to submit a return not submitting a return	% requested to do so not submitting a corporation tax return
2007-08	1,925,000	1,390,000	184,000	1,574,000	72.2%	81.8%	61.8%	351,000	18.2%
2008-09	1,961,000	1,402,000	98,000	1,500,000	71.5%	76.5%	55.8%	461,000	23.5%
2009-10	1,931,000	1,374,000	110,000	1,484,000	71.2%	76.9%	53.6%	447,000	23.1%
2010-11	1,887,000	1,441,000	96,000	1,537,000	76.4%	81.5%	58.4%	350,000	18.5%
2011-12	1,880,000	1,537,000	72,000	1,609,000	81.8%	85.6%	59.9%	271,000	14.4%
Average of above	1,916,800	1,428,800	112,000	1,540,800	74.6%	80.4%	57.9%	376,000	19.6%
2012-13	1,916,000	1,103,000	15,000	1,118,000	57.6%	58.4%	39.1%	798,000	41.6%

**Figure 15**

**Sources: Companies House data and author calculations**

On average over five years 376,000 corporation tax returns requested by HMRC were not submitted, albeit with the situation appearing to improve in 2011/12. This means 19.6 per cent of companies requested to submit a return did not, on average, do so. This, it should be noted, is however, data that is based solely on returns requested so when the number of returns not requested is taken into account, less than 60 per cent on average of all companies actually submit a corporation tax return.

What is also very clear is that this ratio cannot be explained by the number of companies that are dormant. Figure 16 is largely based on data from HMRC on the number of companies paying corporation tax<sup>xxxvii</sup>. It should be noted that:

- Data on the number of companies reporting trading income and taxable profits comes from parliamentary answers used in the course of preparation of this report published separately;
- The total number of companies at the start of the year is from Companies House data;
- Data on total taxable profits is published by HMRC as part of its corporation tax dataset as is the total tax paid and the split between what are referred to here as large and small companies. In practice this split is determined by the size of profit declared, with a large company having profits of more than £350,000 a year and a small company a figure less than that;
- Figures have been adjusted by the government's favoured inflation indicator, the consumer prices index, where indicated to provide some consistency over time for the sake of comparison;
- Remaining figures are computed from the data shown.

	2007-08	2008-09	2009-10	2010-11	2011-12	Average 2007-12
	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted
Number of companies reporting trading income	979	962	968	1,022	1,090	1,004
Number of companies reporting taxable profits	924	890	874	911	980	916
Total number of companies at start of period	2,546	2,687	2,770	2,630	2,686	2,664
Proportion paying tax	36.3%	33.1%	31.6%	34.6%	36.5%	34.4%
Total chargeable profits (£'bil)	218	216	183	172	180	194
Profits per company, average (£)	235,667	242,686	209,402	189,046	184,083	212,177
Tax paid (£'bil) (excluding North Sea taxation)	40.7	33.3	30.8	35.3	32.9	34.6
Tax paid per company, average (£)	44,000	37,370	35,259	38,718	33,596	37,789
Tax bill small companies (£'bil)	11.9	12.0	11.5	11.6	12.1	11.8
Number of small companies (tax data)	833	804	797	831	895	832
Number of large companies (tax data)	91	86	77	80	85	84
Tax paid per small company, average (£)	14,238	14,924	14,449	13,934	13,549	14,219
Tax paid by large companies, average (£)	314,998	247,262	251,709	296,632	243,706	270,861
CPI adjusted tax paid by small companies	16,360	16,417	15,652	14,635	13,549	15,323
CPI adjusted tax paid by large companies	361,964	271,988	272,666	311,567	243,706	292,378
Proportion of companies that are small	90.1%	90.3%	91.2%	91.2%	91.3%	90.8%
Proportion of tax paid by small companies	29.2%	36.1%	37.4%	32.8%	36.8%	34.5%

**Figure 16**

**Sources: Parliamentary answers, HMRC corporation tax statistics, Companies House data and author calculations**

This table shows that just 34.4 per cent of all companies in this period (based on the number in existence during it) on average, paid corporation tax. This, however may not be the most important issue to note: that more important is highlighted in this table:

	2007-08	2008-09	2009-10	2010-11	2011-12	Average 2007-12
	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted
Number of companies reporting trading income	979	962	968	1,022	1,090	1,004
Number of companies submitting tax returns	1,574	1,500	1,484	1,537	1,609	1,541
Difference, which must be dormant tax returns	595	538	516	515	519	537
Number of companies filing dormant accounts	336	362	371	374	392	367
Maximum number of likely dormant companies	476	502	518	492	502	498
Number of dormant tax returns less likely number of dormant companies	119	35	(2)	24	17	38

**Figure 17**

**Sources: Parliamentary answers, HMRC corporation tax statistics, Companies House data and author calculations as noted in text or previous tables**

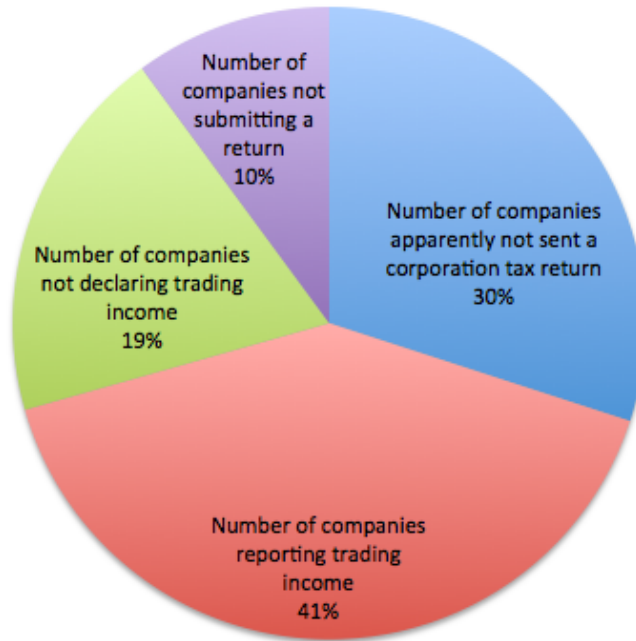
As previously noted, HM Revenue & Customs does not ask for corporation tax returns from about at least 650,000 companies a year in the UK because it thinks they do not trade.

As this data also shows, HMRC also appear to accept that more than 500,000 tax returns declare no income, presumably because the companies say they do not trade.

And it has also said that this data and that in figure 16 shows that HMRC presumes that large numbers of companies do not submit tax returns because they do not trade; the estimates being noted in the tables already provided.

This means that, in the most generous interpretation for a year and considering only the companies in existence at the start of it, Figure 18 shows the breakdown of companies filing corporate tax returns.

### Corporation tax returns 2011-12



**Figure 18**

**Source:** data tables noted above

It is therefore clear that HMRC is willing to accept that at least 59 per cent of companies do not trade, which is not the same as having no income. In total this comes to 1,596,000 companies in all in 2011-12, which is the last year for which reliable data is available.

#### **f. The plausibility of corporation tax return data**

There are a number of reasons for doubting the plausibility of HMRC's tax return data that has been noted above.

Firstly, only around 18.7 per cent of companies register themselves as dormant with Companies House by using dormant company accounts despite the considerable savings in effort that come from doing so. As has been noted above, having allowed for those companies not trading in the UK it is possible that broadly the same ratio of companies tell HMRC they are dormant, again securing some advantage from doing so as a result of not being asked to submit a corporation tax return. The data, while not the same, is not wholly inconsistent from these two data sources.

That said, some companies that claim to be dormant will definitely not be. Once a claim of dormancy has been made, it is almost unchecked by HMRC so the chance of false dormancy claims is very high indeed. This is exacerbated by the fact that HMRC says in its report on the tax gap<sup>xxxviii</sup> in 2013 (page 53):

*Estimates of tax gaps from incorrect returns in this section come from the CTSA [Corporation Tax Self Assessment] random enquiry programme and data on compliance yield and non-payment.*

And (page 55):

*The CTSA random enquiry programme allows HMRC to estimate the extent of under-declaration of liabilities arising from the submission of incorrect returns. The random sample used for the programme is selected from SMEs [Small and Medium sized Enterprises] issued with a notice to file a CTSA return.*

Two conclusions can be drawn. The first is that the companies not sent a tax return are not sampled to see whether or not that population should have actually had a request sent to them. This means that not less than 650,000 companies that declare themselves dormant are effectively as a result not subject to HMRC review. The actual number may be higher if the total number trading in a year is considered. The second is that the focus is on submitted returns. That means the 271,000 companies not submitting returns are likely to receive little attention at all from HMRC.

This lack of attention to companies not submitting returns is only set to increase in the future. HMRC has said in its report on the methodology used to sample corporation tax returns that:<sup>xxxix</sup>

*For CT [Corporation Tax], the random sample is selected from SMEs issued a notice to deliver a return each month. From January 2012, the sampling process selects every 3,000th return, whereas previously it selected every 4,000th return. From April 2013, the sampling process has changed to a stratified random sample, based on the size of annual trading turnover. This change in the selection process is expected to involve selecting fewer smaller traders, which in turn is expected to increase both the accuracy and the yield (under-declared tax liability) resulting from the random enquiry programme.*

This effectively confirms that those companies not required to submit a return are ignored because a systematic bias against sampling small and non-declaring companies is to be built into the investigation programme. This ignores the tax risks inherent in the shadow economy.

It has been claimed in response by HMRC that an approach based on individual company enquiries to establish risk in this population of dormant companies is not necessary as HMRC

relies on taskforces and campaigns to identify this risk. That claim is, however, hard to consider credible since such actions are very often quite locally focused and only look at one business segment at a time. The problem is so broad that such an approach is little better than putting needles in haystacks. In their response to this criticism HMRC appear to suggest that this not the case because they also rely on extensive (but unspecified) database information collection as well. Unfortunately this claim does also not appear to be very credible because if those databases were reliable then local taskforces and campaigns would not be needed as targets would already be known. The HMRC arguments used to justify their approach are self contradictory in the arguments that they offer.

Most importantly though, what HMRC's methodology confirms is the tiny number of corporation tax returns that they actually investigate. In 2011-12 it may have been just 470. In at least 68 of these cases it was likely that no return was submitted. As a control mechanism this is wholly inadequate especially when substantial errors were found in the sample of companies tested by HMRC. That this is the case is clear: HMRC said in its 2013 tax gap report that the rate of errors found had been as high as 42 per cent for smaller companies in 2005-06 and may have been 36 per cent in 2010-11, although it had been lower in between. As will be noted later, remarkably similar mis-declaration rates have also been found in the USA.

This would, perhaps, not matter if the sums involved were not significant but as HMRC notes:

*The proportion of annualised additional liability over £1,000 declined from 19 per cent in 2005-06 to a low of 14 per cent between 2007-08 and 2009-10, before it increased back to 18 per cent in 2010-11. The proportion of annualised additional liability under £1,000 has followed a similar trend across the period. It fell from 23 per cent in 2005-06 to a low of 11-12 per cent between 2007-08 and 2009-10 before subsequently increasing to 19 per cent in 2010-11. However, the 2010-11 proportions should be regarded as provisional.*

It is therefore clear that HMRC know from their own findings that small businesses that submit corporation tax returns make substantial under-declarations of corporation tax. If, as seems likely as a result of reviewing this data, at least 40 per cent of smaller businesses are willing to under-declare their tax liabilities when they know that there is a risk of being caught, the chance of those not asked for a return not declaring income must be at least as high, and maybe somewhat higher. In the five years to 2011-12, 524,000 companies a year on average were not asked to submit tax returns and on average 376,000 of those asked to submit returns did not actually do so. This makes a total of 900,000 companies a year not submitting corporation tax returns. 40 per cent of this total is 360,000. This rate of error, noted it seems rather consistently across returns subject to review by HMRC (and replicated by findings in the USA) might be a fair estimate of the total number of companies who should be submitting corporation tax records but are failing to do so as a consequence.

#### **g. Evidence from VAT data**

There is very strong evidence from HMRC's VAT data<sup>xl</sup> that the number of companies declaring that they have income for corporation tax purposes is understated. References in this section are to tables in the HMRC VAT factsheet unless otherwise noted.

In Figure 19, data from Table 2.9 of that factsheet shows that on average 95 per cent of all UK VAT trading is undertaken by limited companies whilst data from Table 2.8 shows that this is despite the fact that companies only make up just over 60 per cent of total VAT registered entities: numbers for sole traders and partnerships are also shown for the sake of comparison:

<b>Total Annual Net VAT</b>	<b>Incorporated company</b>	<b>Sole proprietor</b>	<b>Partnership</b>
2004-05	926,370	561,750	328,930
2005-06	1,008,070	574,430	329,600
2006-07	1,094,410	564,100	322,120
2007-08	1,155,350	547,680	311,870
2008-09	1,177,280	547,530	302,950
2009-10	1,165,220	532,770	293,210
2010-11	1,180,840	508,080	279,960
2011-12	1,203,130	456,510	256,060
2012-13	1,261,440	447,110	250,150

**Status**

<b>Per cent of Total Annual Net VAT</b>	<b>Incorporated company</b>	<b>Sole proprietor</b>	<b>Partnership</b>
2004-05	50	30	18
2005-06	52	30	17
2006-07	54	28	16
2007-08	56	27	15
2008-09	57	26	15
2009-10	58	26	15
2010-11	59	25	14
2011-12	60	23	13
2012-13	63	22	13

**Figure 19**

**Source: HMRC sourced VAT factsheets, Tables 2.8 and 2.9**

Figure 20 illustrates that there were apparently more VAT registered companies in the 2012-13 tax year than there were reporting that they had taxable turnover for corporation tax purposes.

	<b>VAT registered</b>	<b>Trading for corporation tax</b>	<b>Difference</b>
2007-08	1,155,350	979,273	176,077
2008-09	1,177,280	962,469	214,811
2009-10	1,165,220	968,421	196,799
2010-11	1,180,840	1,021,515	159,325
2011-12	1,203,130	1,089,690	113,440

**Figure 20**

**Source: HMRC sourced VAT factsheets**

However, factsheet Table 2.7 makes clear that some VAT registered business declare no VAT turnover. This could be because they are not trading or falsely declaring their VAT. It may also be that in practice they are registered but are making sales that do not have VAT applied to them and are registered for other purposes e.g. because they are importing services. They could also be failing to declare their turnover properly on their VAT returns but are actually paying VAT despite that fact (a not uncommon occurrence). Assuming, generously, that all are not trading and comparing the resulting data on the number of companies that may not be trading with the total difference noted above the following data is found:

	VAT registered	Trading for corporation tax	Difference	% not trading per VAT returns	Potential number not trading	Unexplained difference
2007-08	1,155,350	979,273	176,077	13	150,196	25,882
2008-09	1,177,280	962,469	214,811	13	153,046	61,765
2009-10	1,165,220	968,421	196,799	13	151,479	45,320
2010-11	1,180,840	1,021,515	159,325	12	141,701	17,624
2011-12	1,203,130	1,089,690	113,440	10	120,313	-6,873

**Figure 21**

**Source: HMRC sourced VAT factsheets**

The difference between VAT data and other data now appears more readily explained, except for the fact that a simple apparent explanations relies on the assumption that all trading companies are VAT registered when very obviously they are not. The requirement to VAT register is only triggered when sales reach a threshold (£79,000 in 2014). Since VAT registration is onerous, many companies turning over less than this sum (which will be true of many labour-only contract supply companies) will not be VAT registered. This VAT data must therefore imply that there are more trading companies than corporation tax returns imply.

#### **h. The Department for Business, Innovation and Skills data**

The Department for Business, Innovation and Skills (“BIS”) publishes its own data on the number of trading companies in the UK.<sup>xii</sup> The latest data set is for 2012-13. BIS estimates that there were 1,395,505 such companies. The equivalent number in 2012 was 1,341, 115.

In coming to this number BIS assumes all limited companies that trade are either VAT registered or have a PAYE scheme so that they can pay staff. By definition therefore there are no businesses in the BIS estimate of the number of trading companies that are not registered with HMRC because they are neither VAT registered nor PAYE registered.

Despite this BIS estimate that there are 250,000 more companies registered as trading in 2011-12 than pay corporation tax. Since the number paying corporation tax is wholly explained by those VAT registered, as noted above, the excess number is therefore presumably the number trading but not VAT registered who are HMRC registered because

they pay staff. This combination would suggest most of these are relatively small, employing only one or two staff.

BIS says that the total number of companies having only one employee / director in 2011-12 is 555,780. The number of VAT registered businesses turning over less than the VAT registration limit in that year, based on HMRC VAT data, is likely to be about 385,000. That means at least 170,000 companies are likely to be trading at below the VAT registration limit and are PAYE registered.

Of course it may be that some PAYE registrations exist where no PAYE is due, but this seems unlikely since the incentive to terminate such registrations is high as penalties for not filing PAYE returns can be significant. It is more likely that this figure of 170,000 companies represents a reasonable estimate of the minimum number of businesses registered with HMRC who are likely to be trading but who did not submit a corporation tax return recording that they were trading during that year.

The number may well be higher than this since it is entirely plausible that there were companies who reported trade that were neither PAYE nor VAT registered. These may be small businesses paying out all their income by way of dividends and who do not therefore operate PAYE (for example, because the owner already pays national insurance and so does not therefore need to pay a salary in the business to get a national insurance credit). This is likely to be commonplace. There are also companies that are not VAT registered themselves but are VAT registered as part of a VAT group, which is another common occurrence, and are therefore trading. It is also possible for a company in a group to trade and not pay salaries because the salaries of those engaged in working for it are paid by another group member, which is again quite a common occurrence. It is impossible to be sure how many companies fall into any of these categories.

The important point is that it is possible that a substantial number of companies, likely to be over 170,000, may well be registered with HMRC as trading and yet still do not record that they have income for corporation tax purposes. This suggests substantial non-compliance with the requirement to declare tax within the system even before taking into account those companies who are not filing returns at all.

#### **i. Evidence from the Office for National Statistics**

There is a final curious piece of evidence on this issue. In April 2013 the Office for National Statistics (ONS) recategorised almost half a million people as employees in the UK when they had previously considered them to be self-employed.<sup>xiii</sup> They gave their reason for doing so to be:

*Cognitive testing carried out by ONS has shown that directors of limited companies often consider themselves to be in the working owner category. However, it is clear from HMRC guidance that these should be classified as employees of the company.*

This survey-based data affirms this report's proposal that substantial category errors can under-record the number of companies considered to be trading in the UK.

## 5. Shadow companies – forming a conclusion

### a. Objectives for this chapter

The previous chapter has:

- Reviewed considerable quantities of data;
- Suggested that more than 300,000 companies are struck off the Register of Companies each year;
- Suggested that over 400,000 companies a year might fail to file annual return forms with the Registrar of Companies, including those struck off;
- Shown that more than 340,000 sets of accounts due to the Registrar of Companies were probably not filed in 2012-13, including those due by companies struck off (the figure being lower than for annual returns because annual returns are due to be submitted before accounts need to be filed);
- Suggested that Companies House data on this issue may be misleading;
- Suggested that at least 650,000 corporation tax returns a year are currently not requested from companies that might be trading;
- Shown that of the companies asked to submit corporation tax returns in 2011-12 more than 270,000 did not do so;
- Suggested that false declaration by smaller companies appears to be commonplace in at least 40% of tax returns submitted and that if this number is extrapolated over the number of companies not being asked to submit tax returns or not submitting them 360,000 companies may not be declaring income each year;
- Revealed that only about 470 investigations of small company corporation tax returns were undertaken by HM Revenue & Customs in 2011-12, an effective rate of less than one for every 5,700 companies that might have submitted a corporation tax return. Very few, if any, of these investigations appear to be of companies that have not submitted corporation tax returns at all;
- Shown that of the number of companies filing tax returns more than 500,000 said they did not trade;
- Shown that even using the most generous of calculations just 41% of all companies actually declared that they were trading in 2011-12 and fewer paid any corporation tax;
- Estimated that it is likely that more than 170,000 companies that trade according to HMRC VAT and PAYE statistics do not declare that they have income for corporation tax purposes;
- Demonstrated that there are good reason to think that the number of companies that are trading and not making declaration of taxable income might be higher than this;
- Drawn attention to the fact that the Office for National Statistics has miscategorised data on trading companies over time requiring a recategorisation of almost 500,000

people as sole company directors in 2013 who were previously considered self employed, suggesting that estimates of the number of trading companies van be be seriously mis-stated.

This chapter will:

- Consider this evidence;
- Suggest that there is a very real problem with companies that are not reporting their taxable income.

#### **b. Considering the evidence**

The evidence noted on missing companies all suggests that there is a serious risk that there are many companies that are not reporting their taxable income.

Reasonable interpretation of Companies House data, linked to the evidence of hundreds of thousands of companies being struck off each year within months of their potentially having traded and without submitting accounts or tax returns as a result, implies that in excess of 340,000 companies a year fail to comply with Companies House requirements to file accounts.

Some of these companies did not trade, of course. That has to be the case. This is accepted as a fact. No one, however, knows how many companies may be in this category. Suppose, however, that the 40% false declaration rate noted in the tax returns of small companies and the self employed is replicated here; that would suggest at least 136,000 companies may not be declaring income based on the number not filing accounts.

By chance, or not, the figure for the number of companies not filing accounts is not that much greater than the number of companies not filing corporation tax returns when asked to do so by HM Revenue & Customs; this estimate of the number of companies that are trading but not declaring that fact will be assumed to cover both these categories of missing data; both are, after all, based on self declaration by the companies in question so the likelihood of coincidence, even if the claim is wrong, is likely to be high.

Suppose too that of the 650,000 or so companies not asked to file corporation tax returns because they have declared that they are not trading there were 40% of companies making false declarations that they were either dormant or that they did not have income in the UK. That may suggest more than 260,000 companies in this group that might have income but that are not declaring that fact.

Finally, assume of the more than 500,000 companies submitting corporation tax returns who said they were dormant 40% did so incorrectly. That could be 200,000 more false declarations.

Based on this 40% error rate commonly reported in HM Revenue & Customs tax gap reports for this category of taxpayers it is therefore plausible that around 600,000 companies may be trading and not reporting the fact in the UK.

It is stressed before it is, almost inevitably, said that all these companies are, surely, dormant, that this estimate would still leave more than 840,000 genuine dormant companies in the UK – about one third of all companies in 2011-12.

To be cautious it is also appropriate to consider the possibility that although the error rate for mis-stated income by small businesses often seems to be quoted at around 40% the error rate may not be as high as this. For example, the lowest error rate reported for under-declarations on small company corporation tax returns investigated by HM Revenue & Customs was 26%, in 2009-10. Even if this rate was substituted for the higher, more common, figure, this would still suggest more than 400,000 companies were trading and not declaring the fact in the UK each year.

By coincidence, or not, this happens to be almost exactly the same rate of non-compliance found for annual returns required to be submitted to Companies House. Such an estimate is, therefore, entirely plausible.

What has to be concluded is that a precise estimate of the number of shadow companies cannot be made; it will always be a matter of chasing shadows but the shadows appear to be long enough to suggest that this rate of at least 400,000 shadow companies operating in the UK economy at any point in time is highly likely to be at least a fair estimate, and that it may actually be much higher still, and that this implies that there is considerable lost tax revenue as a result.

## 6. The cost of the UK's shadow companies

### a. Objectives for this chapter

The previous chapter has:

- Suggested that there may be between 400,000 and 600,000 companies that do not submit corporation tax returns saying they are trading in the UK each year when they might actually be liable to pay tax as a result of doing so;
- Concluded that considerable tax loss arises as a matter of fact and might reasonably be linked to these 'missing' companies as a result.

This chapter will suggest ways of estimating this tax loss.

### b. Why a 'bottom up approach cannot work for estimating the tax lost to the UK's shadow companies

There are a number of ways in which tax lost as a result of the operations of the UK's shadow companies might be estimated.

One is to look at the tax that a typical small company might pay and then estimate the loss that might result for all companies on this basis. However, this assumes that the data supplied by the small companies from which such an estimate might be prepared is reliable. Evidence from HMRC in its tax gap reports suggests that it is highly likely that even the figure for corporation tax paid by smaller companies is systematically under-reported by those companies that do declare that they have income for corporation tax purposes. In that case this may not be the best approach.

There is also the risk that any such estimate might seriously underestimate the overall tax due by smaller companies. Some companies may only pay corporation tax to HMRC, but they will definitely be in the minority. Most will, because of their trading, also owe VAT and PAYE to HMRC, or at least they would if only they declared what they were doing. There is risk that these other taxes will also not be paid if the company does not declare its income for corporation tax purposes. But again, at least with regard to PAYE, the problem is that HMRC estimates of the tax lost are based on returns submitted, and the precise problem being addressed here is that it is far too easy to make no declaration to HMRC and get away with it. This is the inherent weakness within the 'bottom up' approach.

It is precisely because the 'bottom up' approach used by HMRC to estimate the tax gap is so limited that Margaret Hodge MP said to HMRC during a hearing of the Public Accounts Committee<sup>xliii</sup> in October 2013:

*What I was trying to demonstrate by my question is that the tax gap is the tip of the iceberg of the money that is owed between the money that you collect and the money that would be owed if everybody paid their fair share according to either their individual wealth or the profits they make from their economic activity. Have you any idea how big the tax gap would be if you had regard to, for example, tax being paid by Starbucks, Amazon, Google, Apple, eBay and Facebook, or if you had a less optimistic view about the amount of illegal trading that goes on? How big could it be?*

That question from Margaret Hodge is what this chapter is trying to answer. It has to do so because in its reply to Margaret Hodge MP, HMRC said that it could not, or would not, answer this question.

### **c. The top down approach to estimating tax losses**

There are two approaches to 'top down' estimates of tax gaps currently in use. One, used as the basis for the work currently quoted by some in the European Union as the basis for its tax gap estimates,<sup>xliv</sup>, uses data on the size of the total 'shadow economy' to estimate tax lost. This has attraction as a top down approach, but in the current case, attribution of loss to companies is needed and so something more specific is desirable, albeit that this shadow economy data can be used for reasonableness testing of any resulting outcomes.

The second approach is to work from estimates of the amount of VAT not paid in the UK economy. There are two sets of data available for this purpose and significant other corroborating information. The first data set is HMRC's own tax gap data<sup>xlv</sup>. The second is equivalent data from reports prepared for the European Union on this issue.<sup>xlvi</sup> Both use broadly similar methodologies.

With regard to VAT alone HMRC has chosen to estimate its tax gap data on a 'top down basis'. It describes this process as follows:

*The aim is to measure the total level of VAT losses by comparing the net theoretical tax yield with actual VAT receipts. The difference between these amounts is known as the VAT gap.*

*This 'top-down' approach involves:*

- *Gathering data mostly from the ONS detailing the total amount of expenditure in the economy that is subject to VAT;*
- *Estimating the rate of tax on that expenditure based on commodity breakdowns of the expenditure data to derive the gross VAT Total Theoretical Liability;*
- *Subtracting any legitimate refunds (deductions), occurring through schemes and reliefs, to arrive at the net VAT Total Theoretical Liability.*

- *Subtracting actual VAT receipts from the net VAT Total Theoretical Liability; and*
- *Assuming that the residual element, the gap, is the total VAT Gap, including all losses for any cause.*

*The VAT Total Theoretical Liability is the theoretical amount of VAT that would be collected in an ideal world. This means all expenditure subject to tax yielding the full and correct amount of VAT, without fraud, avoidance, and losses due to error or non-compliance.*

This is a theoretically reasonable approach to calculating tax gaps. It is a shame that HMRC only use it for VAT. HMRC's own sensitivity on this issue was highlighted by their commissioning of a report from the International Monetary Fund on this methodological issue in October 2013<sup>xlvii</sup>. HMRC would no doubt draw comfort from the overall conclusion of this report which said (page 8):

*In general, the models and methodologies used by HMRC to estimate the tax gap across taxes are sound and consistent with the general approaches used by other countries. The HMRC programme follows a pattern of employing "bottom-up" based estimates for the direct tax gaps, and "top-down" estimates for the indirect tax gaps. Both approaches are applied consistently with good international practices—in fact, HMRC has been leading the application of some of these methodologies.*

However, it should be noted that the IMF is well versed in the language of extreme diplomacy, and was on this occasion acting as a management consultant, and consultants are unlikely to upset their clients. Even so, in the very next sentence following on from the above section they said:

*Notwithstanding these good practices, there are areas of improvement that would enhance the robustness of the analyses.*

When reading the report in its entirety it becomes very obvious where these concerns arise. For example, with regard to corporation tax they say when seeking to evaluate whether or not the HMRC tax gap properly accounts for all potential forms of non-compliance that the framework used was only 'fair' because 'undetected undeclared liabilities are not being accounted for all taxpayers'.

Their conclusion with regard to unincorporated taxpayers is very similar. With regard to the evaluation of random enquiry-based estimates for non-corporation taxes they say when assessing accounting for undetected undeclared liabilities that these are 'not being accounted for in all cases, values used could be improved'. When considering the use of external data to find undetected undeclared liabilities they say 'further information on this component is necessary to complete the evaluation'.

There is a consistent message that comes from this appraisal, which is that while HMRC is performing a fairly good job of appraising tax risks within those tax returns relating to direct taxes such as corporation tax that it actually receives, their systems for finding undetected and undeclared liabilities, and their systems for estimating the losses resulting from those undetected and undeclared liabilities are ‘fair’ at best. This is precisely why top-down estimates of the sort made in this report are essential. They are the only way in which this missing data can be estimated.

As a consequence estimates of tax losses made in this report are based on the VAT tax gap. This estimate is considered the most likely to provide data on undetected and undeclared income, although as noted below, interpretation is still possible and estimates from the European Union are different from the HMRC’s.

Figure 22 outlines the HMRC estimate of the VAT tax gap made in 2013.

	2007-08	2008-09	2009-10	2010-11	2011-12
Net VTTL	92.8	93.0	80.8	95.3	109.8
Net VAT receipts <sup>2</sup>	82.0	79.8	71.4	85.4	98.4
<b>VAT gap (point estimate)</b>	<b>10.8</b>	<b>13.2</b>	<b>9.4</b>	<b>9.9</b>	<b>11.4</b>
of which MTIC fraud	1.0-1.5	1.0-1.5	1.0-1.5	0.5-1.0	0.5-1.0
of which debt	0.9	2.4	1.8	0.9	1.8
<b>VAT gap (per cent)<sup>3</sup></b>	<b>11.7%</b>	<b>14.2%</b>	<b>11.6%</b>	<b>10.4%</b>	<b>10.4%</b>

**Figure 22**

**Source: HMRC tax gap estimates 2013**

The first line of the table refers to a VTTL – a VAT Total Theoretical Liability – that is, the sum of VAT due if the law operated as HMRC thinks it should on all transactions to which it believes it should be charged.

It is important to note that the decline in the value of the tax gap from 2008 to 2011 was almost entirely down to the cut in the VAT rate to 15 per cent in late 2008. The standard rate is now 20 per cent and with a growing economy it may well be that the absolute value of the loss will increase (see further discussion below).

The percentage rate change is as interesting as the amount lost. The percentage was high in 2008-09 because of bad debts induced by the onset of recession. The rate of loss to what is called MTIC (Missing Trader Intra-Community) fraud is also reported to have fallen. This fraud is organised crime that does not relate to real trade but massive fraudulent trades in high value goods that are notionally moved rapidly across borders and back again until net VAT reclaims are made without matching liabilities being paid, thus fraudulently enriching criminals. This activity (apart from the fact that it takes place through untraced limited companies) has little to do with other losses of concern here and as such can be excluded from extrapolations.

The result is that adjusted losses excluding MTIC are lower than the VAT gap percentage noted above. Allowing for these adjustments and using data over time (additional information being based on the 2009 HMRC tax gap report<sup>xlviii</sup>) Figure 23 on VAT gaps is produced – it is the only tax gap with estimated data back to 2002.

The VAT Gap	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	Average
Effective VAT rate	17.50%	17.50%	17.50%	17.50%	17.50%	17.50%	16.60%	15.60%	19.37%	20.00%	
Estimated VAT due £'bn	75.5	78.7	82.5	86.2	89.5	92.8	93	80.8	95.3	109.8	88.41
Actual VAT receipts £'bn	63.7	69.1	72.8	73	77.6	82	79.8	71.4	85.4	98.4	77.32
VAT gap per HMRC £'bn	11.9	9.5	9.8	13.3	11.9	10.8	13.2	9.4	9.9	11.4	11.11
Gross VAT gap % per HMRC	15.70%	12.10%	11.80%	15.40%	13.30%	11.70%	14.20%	11.60%	10.40%	10.40%	12.66%
Missing Traders £'bn						1.2	1.2	1.2	0.7	0.7	1.00
Bad debt £'bn						0.9	2.4	1.8	0.9	1.8	1.56
Net VAT gap £'bn						8.7	9.6	6.4	8.3	8.9	8.38
Net VAT gap %						9.4%	10.3%	7.9%	8.7%	8.1%	9.5%

**Figure 23**

**Sources: HMRC tax gap estimates as noted and author calculations**

HMRC claims that performance with regard to this gap has improved in recent years although much of this appears to be down to methodological changes based on national statistics data and not real performance change.

It is curious that an EU study on exactly the same subject<sup>xlix</sup> does not agree with this improvement in recent years. The EU study in question is more comprehensive than HMRC's in terms of reporting. It considers each member state of the EU and has more detailed methodology notes. It says of the HMRC work and others like it:

*The method employed in all these studies is a disaggregated 'top-down' approach which applies the appropriate VAT rates to an appropriately segmented final consumption base and then further adjusts the estimated base to take into account the non-deductible input VAT borne by exempt suppliers. This process is not simple. Problems arise both in matching consumption data with VAT bases and rates and in estimating the effects of legal exemptions and non-registrants in different sectors.*

*To deal with the first of these problems, the best approach is, as is done here, to use the most detailed possible consumption (and other base) data from such sources as national accounts, supply-use tables and household survey data. A set of net tax rates that has been as carefully constructed as possible on the basis of the tax code is then applied to this disaggregated base in order to estimate VTTL.*

Figure 24 shows that although the approach is the same, the results differ slightly:

EU VAT GAP Data for the UK	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average
VTTL € mil	121490	125763	131319	125710	136941	139488	149492	156296	137366	105445	130650	150064	134169
VAT Receipts € mil	106512	109188	114583	113314	121812	123766	130571	136404	117292	91229	113714	130577	117414
Difference per EU € mil	14977	16575	16736	12396	15129	15722	18921	19892	20074	14215	16937	19487	16755
% VAT Gap estimate for UK	12.33%	13.18%	12.74%	9.86%	11.05%	11.27%	12.66%	12.73%	14.61%	13.48%	12.96%	12.99%	12.49%
% HMRC estimate			15.70%	12.10%	11.80%	15.40%	13.30%	11.70%	14.20%	11.60%	10.40%	10.40%	12.66%
Net % HMRC estimate								9.4%	10.3%	7.9%	8.7%	8.1%	8.89%
EU VAT gap less UK adjustments								10.40%	10.74%	9.80%	11.27%	10.69%	10.58%
Average VAT gap													9.73%

**Figure 24**

**Source: EU VAT gap estimates as noted in text, HMRC VAT gap estimates and author calculations**

Curiously the average VAT gap over the whole period is almost identical in each survey; what differs is the trend with the EU survey finding neither the highs of early HMRC work or current lower levels of loss. Given that there is no obvious reason for major changes in behaviour in the UK, bar measures to tackle specific fraud, the EU data has more inherent appeal as a result and removes an underlying doubt as to why recent tax gaps have reduced with no obvious explanation from HMRC. That the two are broadly consistent in averaged percentage terms is welcome. Because of its broader based approach and consistency, the EU data for the tax gap is preferred in this study but allowance is being made for the identified losses noted by HMRC and not by the EU study. A notional average current tax gap resulting from broadly based non-compliance by taxpayers with VAT law of 9.73 per cent is to be used in the analysis that follows.<sup>1</sup>

#### d. What the VAT gap means

The question to then be asked is what this VAT gap implies. If HMRC is to be believed this loss stands alone in its tax gap estimates. Figure 25 shows those estimates as a whole in their 2013 tax gap report:

Tax	Type	Point estimates (£ billion) <sup>1</sup>						
		2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Value Added Tax	<b>Total VAT</b>	12.3	11.5	10.8	13.2	9.4	9.9	11.4
Excise duties	Tobacco duties	2.1	2.0	1.6	1.7	1.7	1.3	1.3
	Alcohol duties	0.5	0.6	0.9	0.6	0.6	1.1	0.7
	Hydrocarbon oils duties	0.8	0.8	0.7	0.8	0.8	0.5	0.4
	Other excise duties	0.2	0.2	0.2	0.2	0.2	0.1	0.1
	<b>Total excise duties</b>	<b>3.5</b>	<b>3.6</b>	<b>3.4</b>	<b>3.3</b>	<b>3.3</b>	<b>3.1</b>	<b>2.5</b>
Income Tax, National Insurance Contributions, Capital Gains Tax <sup>2</sup>	Self Assessment	5.4	5.9	7.6	4.8	5.6	5.3	5.2
	PAYE	3.1	3.1	3.3	2.8	3.2	3.8	3.8
	Avoidance	N/A	N/A	N/A	N/A	N/A	N/A	2.0
	Hidden economy	N/A	N/A	N/A	N/A	N/A	N/A	4.3
	<b>Total IT, NICs, CGT</b>	<b>12.5</b>	<b>13.1</b>	<b>15.3</b>	<b>12.3</b>	<b>14.8</b>	<b>15.3</b>	<b>15.3</b>
Corporation Tax	Small and medium businesses	1.8	1.7	1.7	1.9	1.3	2.0	2.3
	Large businesses	3.7	3.5	3.2	3.2	2.2	2.7	2.3
	<b>Total Corporation Tax</b>	<b>5.6</b>	<b>5.1</b>	<b>4.9</b>	<b>5.0</b>	<b>3.6</b>	<b>4.7</b>	<b>4.7</b>
Other direct and indirect taxes	Stamp duties	1.1	1.3	1.4	1.4	0.2	0.2	0.2
	Other taxes <sup>3</sup>	0.8	0.8	0.9	0.8	0.8	0.8	0.8
	<b>Total other direct and indirect taxes</b>	<b>1.9</b>	<b>2.2</b>	<b>2.3</b>	<b>2.2</b>	<b>1.0</b>	<b>1.1</b>	<b>1.1</b>
<b>Total tax gap</b>	<b>36</b>	<b>36</b>	<b>37</b>	<b>36</b>	<b>32</b>	<b>34</b>	<b>35</b>	
<b>Total theoretical tax liabilities</b>		<b>434</b>	<b>459</b>	<b>488</b>	<b>475</b>	<b>441</b>	<b>481</b>	<b>502</b>
<b>Total percentage tax gap (%)</b>		<b>8.3%</b>	<b>7.7%</b>	<b>7.5%</b>	<b>7.6%</b>	<b>7.3%</b>	<b>7.1%</b>	<b>7.0%</b>

Figure 25

Purple data is estimated.

Source: HMRC 2013 tax gap estimates

In percentage terms the gaps are as follows:

Tax	Type	Percentage tax gap						
		2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Value Added Tax		14.4%	12.9%	11.7%	14.2%	11.6%	10.4%	10.4%
Excise duties	Tobacco duties	N/A	N/A	16.5%	17.1%	16.2%	12.4%	12.0%
	Alcohol duties	N/A	N/A	10.0%	6.4%	6.9%	11.0%	6.6%
	Hydrocarbon oils duties	N/A	N/A	2.8%	3.3%	2.8%	2.0%	1.5%
	Other excise duties	N/A	N/A	7.0%	6.0%	6.0%	6.0%	5.0%
	<b>Total excise duties</b>	<b>8.0%</b>	<b>8.0%</b>	<b>7.4%</b>	<b>7.2%</b>	<b>6.7%</b>	<b>6.1%</b>	<b>4.9%</b>
Income Tax, National Insurance Contributions, Capital Gains Tax (IT, NICs, CGT) <sup>2</sup>	Self Assessment	20.3%	19.5%	21.5%	13.7%	18.7%	17.0%	17.4%
	PAYE	1.5%	1.4%	1.5%	1.3%	1.5%	1.7%	1.7%
	Avoidance	N/A	N/A	N/A	N/A	N/A	N/A	N/A
	Hidden economy	N/A	N/A	N/A	N/A	N/A	N/A	N/A
	<b>Total IT, NICs, CGT</b>	<b>5.4%</b>	<b>5.3%</b>	<b>5.7%</b>	<b>4.7%</b>	<b>5.9%</b>	<b>5.9%</b>	<b>5.8%</b>
Corporation Tax	Small and medium businesses	13.1%	11.1%	10.9%	11.6%	8.6%	11.9%	11.9%
	Large business	N/A	10.1%	9.0%	9.9%	9.3%	9.0%	8.0%
	<b>Total Corporation Tax</b>	<b>11.8%</b>	<b>10.4%</b>	<b>9.6%</b>	<b>10.5%</b>	<b>9.0%</b>	<b>10.1%</b>	<b>9.6%</b>
Other direct and indirect taxes	Stamp duties	N/A	N/A	9.0%	14.9%	2.4%	2.5%	2.5%
	Other taxes <sup>3</sup>	3.2%	3.1%	6.0%	5.3%	6.5%	5.7%	5.2%
	<b>Total other direct and indirect taxes</b>	<b>7.3%</b>	<b>7.5%</b>	<b>7.5%</b>	<b>9.0%</b>	<b>4.9%</b>	<b>4.5%</b>	<b>4.2%</b>
<b>Total tax gap</b>	<b>8.3%</b>	<b>7.7%</b>	<b>7.5%</b>	<b>7.6%</b>	<b>7.3%</b>	<b>7.1%</b>	<b>7.0%</b>	

**Figure 25a**

The VAT gap is second only to the tobacco duty gap, the self-assessment gap and the small and medium sized business corporation tax gap. The tobacco gap can be ignored here since it is almost entirely due to crime.

The self-assessment and small company tax gaps are interesting as they are of broadly similar apparent scale to the VAT gap, but this is very misleading when coming to calculating the total likely UK tax gap. This is because, first of all, as already noted, they are calculated on the basis of tiny samples of tax return investigations and both are prepared on a 'bottom up' basis that only considers returns submitted. More importantly, these measures are also narrowly focused. These gaps report the error in the declared profits for self-assessment and the declared profits for corporation tax. They are, therefore on a totally different scale to the VAT gap, as is indicated by their values.

VAT is charged on sales. Admittedly it is not charged on all UK sales. As the EU study on VAT gaps has shown, the consequence of VAT being charged in the UK on only some sales, (because some are exempt, some are zero rated and others are made by organisations who are allowed not to be VAT registered) is that the UK collects just 53 per cent of the VAT it might. In other words 47 per cent of VAT is not collected as a result of policy and not taxpayer non-compliance. When combining the VAT gap (which is based on actual policy) and the policy gap the total VAT gap in the UK is 53 per cent according to this study.<sup>ii</sup>

This is important and has to be placed in context. It is not being suggested that the 47 per cent of VAT not collected is part of the tax gap. This VAT is not collected because the law says it is not due. The relevance of this gap in the context of this report is in estimating total unrecorded sales. The suggestion is that the VAT gap relates to a loss on just 53 per cent of all sales, but that the total direct tax lost will be on a much bigger figure. It is likely that if there are substantial unrecorded sales on which VAT should be charged then that will also be the case for sales on which VAT does not need to be charged. This has nothing per se to do with the policy decision to not charge VAT on those sales. It has to do with the fact that it

is assumed that those who do not need to charge VAT - whether they are businesses trading at below the VAT registration threshold, or those making zero rated and exempt VAT supplies - are just as likely to suppress their income for income tax and corporation tax purposes as those who should charge VAT. This reference to the VAT policy gap is necessary simply to estimate the likely lost sales of this group who trade but do not charge VAT, and not for any other purpose.

What must be understood for the purposes of the analysis that follows is that VAT is never suppressed on a sale that is recorded for a company's accounting purposes. This is because it would be glaringly obvious from the most cursory inspection of a company's accounting records that this had occurred and a fraud would be highlighted immediately on any VAT or tax inspection. Indeed, one of the first checks that any VAT inspector from HMRC makes when checking a company's records is that the sales declared for VAT purposes agree with the sales declared for income tax or corporation tax purposes.

So if VAT is not paid to HMRC by a business it follows that the sale to which that VAT relates is also not recorded. That means the direct taxes due on that sale such as income tax, national insurance and corporation tax are also lost. This will also be true on the unrecorded sales of those businesses that do not have to charge VAT because they are too small to register for that tax. Unfortunately HMRC does not make the logical step that if VAT is lost so too are other, direct taxes, when estimating tax gaps because it is dedicated to preparing 'bottom up' single tax estimates rather than methodologically sound top down estimates of loss.

An example might help to illustrate this point. Suppose VAT was suppressed on a sale of £5,000. The VAT in question is £1,000. That loss of £1,000 of VAT is recorded as a part of the tax gap by HMRC. A total sale value of £6,000 should have been recorded in this situation but that is not the whole loss. Tax on the net sum of £5,000 after VAT is also lost. There are a number of taxes that may be due on this sum. If the sum was simply left as profit in the company that failed to record it, corporation tax at 20 per cent might be due, or £1,000. However, that will not be the case. The company will not record the cash and it will instead pass it on to a human being, who will likely pocket the funds. But this means that this person will, for legal purposes, have been paid by the company in question and PAYE should be applied.<sup>lii</sup>

If the person committing the fraud is on average (median) pay and assuming they have other income on which they are already paying tax, as may well be the case, then the tax due would be likely to be:

- Employer's national insurance at 13.8 per cent. This is calculated as £5,000 x 13.8/113.8 since the cash available is the gross sum out of which all tax is paid. The tax loss is £606. This leaves a net sum available to pay a salary of £4,394.
- Tax is due on this net sum at 20 per cent. The loss is £879.
- Employer's national insurance is also due. This is at 12 per cent. The loss is £527.

- The total PAYE lost is £2,012 or 40.24 per cent.

The VAT loss of £1,000 now has a total combined tax lost cost of between £2,000 and £3,012.

Other possibilities exist. Suppose the person taking the cash is a higher rate taxpayer. The employer's national insurance loss would remain the same but the income tax loss would rise to £1,758. The employee's national insurance loss would likely fall to £88. Now the total combined loss would be £3,452 out of the £6,000 sale or £2,452 out of the £5,000 net sale had it been properly recorded (49%).

There are still further possibilities. It could be argued that the sale proceeds may have been used to buy materials to make the sale. In that case the persons making these sales would, however, have already (probably) been subject to tax and most likely to VAT and it could therefore be argued that the loss is not VAT on the whole sum or tax on all the unaccounted for sale. In that case if such a situation arises the VAT loss is not £1,000, it is instead the VAT on the margin of what should have been the net sale less the cost expended to make it that is lost and likewise the tax that is not paid is also that due on that margin. This is wholly consistent with the logic of the tax gap, which is calculated on end consumption. All that intermediate costs implies is that the company failing to charge VAT on the end supply has in this case itself become, in part, the end consumer, and the loss of VAT as a result of its actions is that due on its margin. This does not then change the percentage sums loss in this case, they are just calculated in this particular situation on smaller sums.

This suggestion is consistent with the inherent logic of VAT where if VAT had been charged on the purchase costs incurred by the company that company, if VAT registered, would have been allowed to reclaim VAT charged to it; the effect is always cumulative in creating an end consumer VAT charge. If that end consumer VAT charge is therefore lost, as the top down calculation of the VAT gap necessarily implies, it always follows that it is VAT on the margin of output less input of the entity that should be charging VAT (but is not) that is evaded and never VAT on the whole turnover. The consequence is that it is, for extrapolation purposes, reasonable to assume that the whole sales figure on which VAT is lost in this example should be subject to tax as income, whether to corporation tax or PAYE.

Because of the cumulative way in which VAT recording takes place, with the VAT chargeable sales from one VAT registered trader are subject to VAT reclaim by another registered trader if made for business purposes. Consequently, the VAT gap effectively measures the resulting missing sales margin that is not recorded within accounting systems rather than total unrecorded turnover. In practice, when calculating the VAT gap the cost of purchases within the business community are offset against sales before that lost margin is calculated. As a result, extrapolating the missing VAT margin that the VAT gap reveals to estimate direct tax losses means that no consideration need be given to any purchases by businesses that are completely suppressing their activities for tax declaration purposes. Since those costs have already been accounted for in estimating the VAT loss, to disallow them again when

estimating a resulting direct tax gap would be to effectively double count them when estimating corporation and income tax losses.

The other possibility is that the margin is used to pay very low waged labour which is not subject to PAYE or national insurance. However, the chance that all unrecorded sales noted below could be expended in this way is remote. It also seems unlikely that the combined tax rate would fall overall below the 20 per cent rate that might be due on corporate profits, given the considerable sums involved.

How do the sums noted extrapolate to calculate the value of the unrecorded sales margin? The first stage finds the value of sales lost based on the average recorded tax gap of 9.73 per cent as if all the missing sales were at 20 per cent, the VAT standard rate. This requires that this percentage be multiplied by five (the inverse of 20 per cent) to give lost sales of 48.67 per cent of the VAT Total Theoretical Liability. Then this resulting figure has to be grossed up to allow for the fact that 47 per cent of sales are not subject to VAT, as noted by the EU, to allow for the fact that the VTTL does not take such sales into account. Doing this gives a gross implied loss of turnover in the economy based on the level of unrecorded sales that the VAT gap implies. The resulting sum of unrecorded sales is 91.83 per cent of the VAT Total Theoretical Liability.

The UK says the VTTL in 2011/12 was £109.8bn. Unrecorded sales on this basis in the economy as a whole would therefore be £100.1bn that year.

Perhaps surprisingly, the EU claims that the VAT collected by the UK was higher than the UK records. This has been ignored for the purposes of the paper; the data noted above regarding the VAT gap accords very closely with HM Treasury budget data.<sup>liii</sup>

An estimate of the resulting overall tax lost can then be done in a number of ways. It could be based on the overall tax rate due on unrecorded income of £100bn. For example, in 2011-12 about 36 per cent of GDP was paid in tax.<sup>liv</sup> This would imply an overall loss of £36bn arising from this tax gap.

This rate of loss happens to fall in the mid-range of the estimates of overall tax lost in the example noted on such a level of unrecorded turnover, but that is slightly misleading as those estimates were only for corporation tax, national insurance and income tax and VAT is, of course, lost as well, albeit that this would not be in the sum of £1,000 as noted in the example, because only 53 per cent of potential turnover is effectively subject to VAT in the UK, meaning that a lower sum (£530 in the example noted) should apply to the lost revenue. This would then imply lost tax in a range of 25.3 per cent to 54.3 per cent based on the example. The mid-point might then be about 39.8 per cent, implying an overall figure of around £40bn of tax lost in 2011-12.

It is this figure that will be used for further analysis here. It is stressed it is indicative and within a range which unfortunately, and unusually, cannot be very easily be specified

because neither the UK nor EU provide range estimates for their VAT tax gap data. It is, however, considered reasonable to take a figure that is above the average for tax paid per £100bn of GDP because this tax lost will represent the top part of income for many who will be enjoying these illicit gains and as such it is fair to assume, in a progressive tax system, that higher than average rates of tax will therefore apply to it. Indeed, the rate used is an indication of some caution in this regard. Significantly higher yields could quite reasonably be estimated (as indicated by the higher estimates of tax and NIC due in the example noted above) simply because there can be no doubt that many involved in tax evasion will be doing so to avoid higher rates of tax. However, for now this mid-point is considered appropriate. These parameters alone, and the relative consistency of the VAT data suggest that the estimate may be in a range from £36bn to £44bn.

It is stressed when saying so that this is not a figure for the whole UK tax gap. It is clearly not. It covers only those items that may have VAT charged on them. So it does not cover any taxes on wealth, investment income, trading not involving VAT (such as financial dealing in the City of London), capital gains, inheritance and council taxes or some parts of foreign sourced income.

Neither does it cover losses arising in areas outside the scope of VAT such as state education, the NHS, the armed forces, and other aspects of government activity not subject to VAT. This is apparent from the fact that the VTTL when grossed up as a whole for 2011/12 suggests total potential gross VAT chargeable sales of just over £1 trillion when GDP was £1,526bn that year. This gap relates to about 68 per cent of economic activity. It is inconceivable that there is no tax gap in the remaining part.

Nor does this gap cover any avoidance issues or bad debt or error and, mistakes or specific fraud, such as missing trader fraud, which have been specifically excluded from the calculation base. Nor does this figure cover the use of offshore, which is outside the scope of UK VAT. It is just the tax that may be lost from the suppression of sales data.

It is important to note though that this suppression of sales data is in itself one measure of the shadow economy (but not a complete one). The implied shadow economy rate for 2011-12 based on this missing sales data is 6.6 per cent (£100bn unrecorded in official GDP of £1,526bn). To put this figure in context, the most frequently quoted expert on measuring the size of shadow economies is Prof Friedrich Schneider of Johannes Kepler University, Linz, Austria. His estimates of the UK shadow economy vary a little over time but tend to suggest a figure of 12.5 per cent on average,<sup>lv</sup> including figures stated in work peer reviewed for the World Bank.<sup>lvi</sup> Therefore the resulting lost sales income noted here is a cautious estimate and well within the size of the potential UK shadow economy estimated by others.

This figure is also smaller than the loss the UK will be suffering in 2014-15. There are two good reasons for this. The first is that the UK's GDP is growing and is forecast to rise from £1,526bn<sup>lvii</sup> in the 2011-12 tax year, on which year's data this estimate is based, to £2,026bn in 2018-19.

The second reason is that the VAT gap has been forecast by HM Treasury to rise to 11.4 per cent in 2012-13 and 10.8 per cent in 2013-14 before returning to 10.4 per cent thereafter.<sup>lviii</sup> This compares to a Treasury figure for this gap<sup>lix</sup> of 9.5 per cent for 2011-12. It is a little hard to be sure what this forecast VAT gap number represents. It is 0.1 per cent different from the HMRC VAT gap in 2011-12 excluding bad debt. What is clear however is that if this gap is to rise, as predicted, forecasts of the resulting losses need to allow for this. This has been done by averaging this forecast rate with the EU rate (which has consistently been around 13 per cent) before subtracting an allowance for bad debt (1.5 per cent based on recent averages) giving the following forecast VAT gaps:

Forecast VAT gaps	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
EU	13	13	13	13	13	13	13	13
UK budget	9.5	11.4	10.8	10.4	10.4	10.4	10.4	10.4
Average	11.25	12.2	11.9	11.7	11.7	11.7	11.7	11.7
Less, ad debt	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
VAT Gap used	9.75	10.7	10.4	10.2	10.2	10.2	10.2	10.2

**Figure 26**

**Sources: EU VAT gap data, HMRC Vat gap data, Office for Budget Responsibility budget forecasts published as part of HM Treasury budget data and author calculations**

The resulting forecast losses are:

Forecast VAT gap data	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
GDP £'bn	1526	1570	1642	1712	1777	1857	1940	2026
VAT gap	9.73%	10.7%	10.4%	10.2%	10.2%	10.2%	10.2%	10.2%
VTTL £'bn	109.8	113.0	118.1	123.2	127.9	133.6	139.6	145.8
VAT gap £'bn	10.7	12.1	12.3	12.6	13.0	13.6	14.2	14.9
Estimated unrecorded sales £'bn	100.8	114.0	115.9	118.5	123.0	128.6	134.3	140.3
% of GDP unrecorded	6.6%	7.3%	7.1%	6.9%	6.9%	6.9%	6.9%	6.9%
Tax likely to be lost on unrecorded sales £'bn	40.3	45.6	46.4	47.4	49.2	51.4	53.7	56.1

**Figure 26a**

**Sources: As previous table**

This forecasting basis closely reproduces the 2011/12 outcome noted above. The forecasts are, of course, indicative and subject to the accuracy of Office for Budget Responsibility data. What is clear is that the problem of the VAT gap, the resulting tax gap and of unrecorded sales in the UK economy is unlikely to go away without serious action to address the issue, Indeed it will increase significantly in terms of tax lost over the rest of the current decade.

#### **e. Is it reasonable to suggest a tax gap bigger than HMRC suggests?**

This report is, then, suggesting that there is an implied overall tax gap that is much bigger than that which HMRC suggests exists because of the use of an entirely different methodological approach to its calculation in this report to that which HMRC use.

It is this last point that is important when deciding whether or not it is reasonable to think that the tax gap might be much bigger than HMRC suggest to be the case. The fundamental

issue giving rise to the difference between the estimate of the tax gap relating to missing sales income suggested here and that which HM Revenue & Customs might suggest is the methodology used.

HMRC use a 'bottom up' approach to estimate the tax gap; they use the data available from their internal evaluations of the reliability of the tax returns they receive (based on a tiny number of sample tax investigations in proportion to the size of the population as a whole) and then extrapolate from that base. The problem is that this sample base by definition excludes those who choose not to submit tax returns and that problem is exacerbated by the fact that in the case of companies HMRC chooses not to ask hundreds of thousands of companies a year to submit tax returns and then apparently does not investigate whether or not that choice was appropriate, or not. The consequence is that a large part of the shadow economy is bound not to be identified by HMRC's approach. The IMF, as has already been noted, think that HMRC methodology in this area is relatively weak.

The 'top down' approach adopted in this study is based on HMRC's own top down estimate of the VAT gap, not least because it is broadly consistent with other studies. Simply applying logical analysis to that data then produces an outcome that is likely to include the whole of the shadow economy that is not recording its sales income and the total resulting tax loss arising from that action.

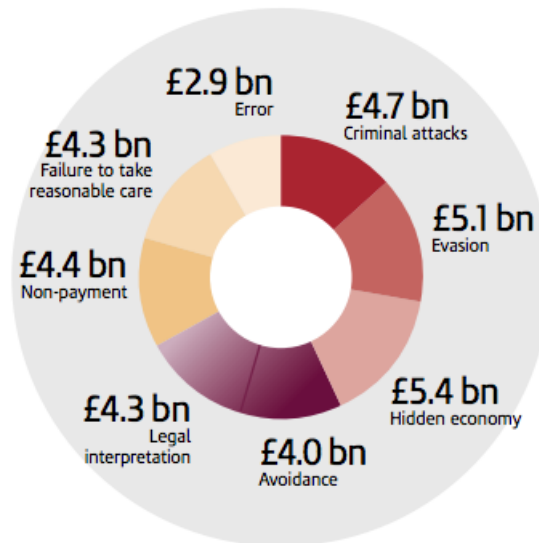
The resulting numbers are fundamentally different. HMRC's might be said to measure errors in the tax system, and this report's to measure the errors outside it. It so happens that there appear to be considerable errors outside the system.

**f. How much of the VAT and tax gaps relates to shadow companies?**

Estimating how much of the missing tax relates to missing companies cannot ever be an exact exercise.

The split of the HMRC tax gap is as follows:<sup>lx</sup>

### Value of the tax gap by behaviour



**Figure 27**

The loss estimated in this report is covered by only two of the HMRC categories - evasion and the hidden economy. It excludes bad debt and criminal attacks while avoidance and legal interpretation can both be reasonably categorised as avoidance activity, which is quite different in its nature from what is being considered in this report. Error and failure to take care within the returns submitted do not relate to unrecorded and not declared income. Taking this data into consideration, £10.5bn (£5.1bn plus £5.4bn) of the tax gap relating to unrecorded income is recognised within the returns that HMRC receive. This leaves the possibility that £29.5bn (the estimate of £40 billion lost in 2011/12 suggested in this report less than £10.5 billion notes) could relate to missing companies or missing self-employments.

There are, broadly speaking, four causes for this loss:

- Firstly it could be existing and declared self employed people suppressing part of their turnover;
- Second, it could be individuals not declaring self-employed income at all;
- Thirdly it could be existing companies that are declaring they have taxable income under declaring their true profits;
- Lastly, it could be the income of the 'missing companies' noted in this report.

The reality is almost certainly a combination of all of these things.

It is important in this context to realise just how limited the reported income of most self-employed people is. As Richard Murphy, author of this report, noted in another report<sup>lxi</sup> in November 2013, the average earnings of a self-employed person earning less than £100,000 in the UK declared to HMRC fell in real terms for over a decade to just £10,400 in 2010-11, the last year for which reliable data was available when that research was undertaken.

While Office for National Statistics data would suggest that higher incomes are earned by those who consider self-employment their sole or main economic activity, the fact remains that the scale of many self-employments is very small even if their overall number (more than three million in 2012/13 according to the Department of Business, Innovation and Skills but with no more than half a million of those employing anyone but the owner, and over 5 million according to HMRC) is large.

This data on self-employment, including the massive ambiguities within it as to the number having that status, is relatively easy to explain. Firstly, self-employment status often suits a peripheral, temporary or secondary activity (e.g. a second source of income), where risk is low and the likelihood of duration of the activity is unknown. When these situations are combined with an expectation of low earnings then the flexibility of self-employment status, with its very low administrative burdens, also suits many. In addition, there are very few tax incentives for those on low income to incorporate.

Self-employed status has another attraction as well: it is easy to disguise. It is possible for many self-employed people to participate only in the cash economy, and a separate business bank account is by no means a pre-requisite for business success. In that case for anyone wanting to tax evade self employment has appeal.

All that being said, and despite the fact that many millions in self employment may tax evade (an observation based on HMRC's own tax gap data, where they suggest that on average at least 40% of all self employed tax returns have understated income over the period 2005-06 to 2009-10 they must think at least 2 million in this activity<sup>lxii</sup>) and that this fact does, of course impact on the tax gap, it is unlikely to explain most of the missing billions in unrecorded turnover noted in this report.

Assuming that more than three million self-employed people may on average suppress £2,000 of tax liability each (which, firstly means some will not do anything of the sort and some will do very much more, but which sum equates to a little less than £7,000 of income suppressed on average by each self employed person or almost exactly 40% of their average income when related to declared average earnings grossed up for this undeclared element having taken both tax and national insurance into account) this would still leaves the average self-employed person's income significantly below UK median income of around £26,800<sup>lxiii</sup> at little more than £17,000, or just over the point where it is assumed a person might suffering poverty.

In this case, using the figure for the number of self employed that the ONS suggest likely (3.9 million in 2011, but with that figure having risen by now) and this estimate for tax evaded on average, then this might suggest that maybe £7 to £8bn of lost tax could be attributed to this group, whilst still acknowledging that many in this category will, of course, submit honest tax returns.

It would of course be tempting to suggest that this sum is covered by the HMRC figure for tax evasion, but this is unlikely. That figure is £10.5 billion, a sum quite close to the cost of

the VAT gap. Since the vast majority of self employed people are not VAT registered as their incomes would never require it there looks to be little overlap between the two categories and as such no significant part of this is likely to be included in the HMRC estimate. It therefore most likely contributes to the missing billions identified in this report.

This is not true, however, of the second category of lost tax, which is the unreported income of those who never declare themselves to be self-employed at all. Richard Murphy's work<sup>lxiv</sup> shows that in 2010-11 HMRC thought that there were 5.1 million self-employed people but the ONS recognised only 3.9 million, the rest being considered to have too low an income to count. The ratio of the two (based on the ONS data) of 31 per cent declaring that they were self-employed but declaring very low income falls into what is now apparent from this report to be the 'normal' range of mis-declaration that both HMRC and the US Treasury note with regard to self-employed income, where up to 40% mis-declaration rates, whether of amounts or those partaking in the practice, seem commonplace. If all those falling between the two definitions had average declared self-employed income (that is £10,400, as noted above), about £12.5bn of income would be misdeclared, most of it probably by people who already have another source of income with tax being due at the 20 per cent income tax rate as a result but with only modest national insurance payable. However, as the resulting loss of income would be a little over £2.5bn, and this is only a little less than HMRC's estimate of £3.2bn for moonlighters and ghosts (the former having partially declared income and the latter none) in this case it seems likely that this loss is covered by estimates already within HMRC's total tax gap calculations and so no further adjustment is needed as a result.

This then leaves about £22bn of missing tax revenue in 2011-12 to be explained by the activities of the corporate sector, over and above the loss arising from VAT that largely explains most of HMRC's tax gap data for evasion. As noted above, this loss must be in two parts. The first is income not declared by companies who do, however, submit corporation tax returns to HMRC and an additional sum by those who operate as 'shadow companies'.

There can also be no doubt that many of the smaller companies that do file tax returns understate their income. The US Treasury estimates on under-reported income, already noted, suggest that the average under-declaration rate by US companies with asset worth of less than US\$10 million may be as high as 29% of the true sum owing. This is less than the rate for the self-employed but still very significant. HMRC themselves admit that over a six year period 31% of small company corporation tax returns under-declared income owing<sup>lxv</sup>. The figures are not strictly comparable: the coincidences with the patterns found regarding self employment where both ratios were in the low 40% range are, however, striking even if the overall rate of under-declaration does appear to be lower.

In this case it is, however, important to note that the scale (as opposed to percentage rate) of income declared by these companies is much higher on average than that of the self-employed. The inflation adjusted average corporation tax payment of smaller companies (broadly, those with profits of less than £350,000) has been remarkably consistent over many years, as Figure 28 shows.

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	Average 2007-12
	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted	Thousands unless noted
Tax bill small companies (£'bil)	5.7	6.4	6.9	8.0	9.2	10.2	11.9	12.0	11.5	11.6	12.1	11.8
Number of small companies (tax data)	471.0	518.3	646.8	755.4	812.7	798.1	833	804	797	831	895	832
Tax paid per small company, average (£)	12,136	12,379	10,659	10,546	11,316	12,815	14,238	14,924	14,449	13,934	13,549	14,219
CPI adjusted tax paid by small companies	15,506	15,619	13,268	12,969	13,597	15,026	16,360	16,417	15,652	14,635	13,549	15,323
Proportion of companies that are small	89.5%	89.7%	90.7%	91.2%	90.8%	90.0%	90.1%	90.3%	91.2%	91.2%	91.3%	90.8%
Proportion of tax paid by small companies	19.9%	24.9%	27.5%	26.8%	26.6%	27.2%	29.2%	36.1%	37.4%	32.8%	36.8%	34.5%

**Figure 28**

**Source: HMRC corporation tax statistics. ONS data on the consumer prices index and author calculations**

If those companies are paying over £13,000 on average each in corporation tax then each has profits that on average amount to in excess of £65,000 a year. This fact is also apparent in data for corporation tax paid issued by HMRC<sup>lxvi</sup> for the 2011-12 tax year:

<b>Corporation tax payable Classified by size</b>		
Numbers: actual; Amounts: £ millions		
Amount of tax payable (lower limit) £	2011-12	
	Numbers	Amount
>0	50,321	2
100	63,711	18
500	54,305	40
1,000	272,437	759
5,000	193,162	1,401
10,000	283,966	5,735
50,000	28,630	1,957
100,000	22,572	4,590
500,000	2,919	2,018
1,000,000	2,539	5,193
5,000,000	370	2,610
10,000,000	369	7,291
50,000,000	46	3,068
100,000,000	35	9,074
<b>All ranges</b>	<b>975,385</b>	<b>43,755</b>

**Figure 29**

**Source: as noted in text**

Large numbers of companies pay significantly more than £10,000 a year in corporation tax, albeit that preponderance do not. However looked at this means that the scale of activity amongst companies is much higher than for the self-employed.

According to VAT statistics it is also clear that about 95 per cent of all trading turnover in the UK is undertaken by limited companies.<sup>lxvii</sup> In that case it is reasonable to think that this is where much of the missing trade noted in this report must be taking place. So what part of

this is down to companies who actually submit returns and what part is due by those who do not?

If, as the IRS suggest smaller companies understate their income by 31% of the true figure then the total corporation tax underpaid by these companies based on the data in Figure 28 would be approximately £5.1 billion a year. This is an estimate that is higher than HMRC would recognise: they only think that approximately this number of returns include errors and that the overall error rate is split approximately equally between those with errors of less than £1,000 and those with errors of greater amount (with no upper limit specified). This would certainly imply a much lower tax gap than IRS data would suggest, but, as has been noted, the HMRC sample base is very small, potentially covering fewer than 500 companies a year.

That said, as has already been explained, it seems much more likely that small company tax evasion results in losses of VAT and PAYE and not corporation tax because the owners take the missing income to use for their own purposes. In that case it is income tax and national insurance, plus VAT, of course, that are the more likely losses arising as a result of small company tax evasion that involves the top part of an income of a limited company not being declared for tax purposes, which is the most likely scenario being considered here.

Based on data in Table 2.7 of the VAT Factbook published by HMRC it is likely that 95% of all companies have turnover of less than £1 million, and 84% have turnover of less than £500,000 which is very likely to make them the small companies being considered here. The scale of activity of these companies is therefore, in aggregate and on average, much larger than for the self-employed, albeit some companies are quite small. That is because, unlike most of the self employed, some of these companies (although by no means all of them) will have employees other than their owners. The overall capacity to disguise missing income in the accounts of these companies is, therefore, in many cases much greater than that which the self-employed have. This factor also has to be taken into account in estimating the tax loss to these companies.

Considering these facts together it might, more realistically, assumed that if 30% of the companies reporting trading income (i.e. approximately 330,000 companies) reported income that was at least 30% less than that likely to be due then £1.3 billion of corporation tax would have been evaded by these companies. This is a sum within the range of HMRC's own estimate on this issue in its 2013 tax gap estimates (page7).

However, this loss ignores the VAT and PAYE losses and if corporation tax is being lost then the evidence from the VAT gap is that both of these taxes will also be subject to more considerable losses. Figure 16 suggests that about 35% of all corporation tax is paid by small companies in the UK. There is, unfortunately, no way of knowing precisely what this might imply for lost PAYE (income tax and national insurance) or VAT paid, but a rational approach to estimation has to be adopted. In the tax year 2011/12, to which these estimates apply, corporation tax revenues were £44 billion, VAT £98 billion and PAYE about £233 billion<sup>lxviii</sup>. If

it was assumed that the same ratio between these revenues applied when estimating the overall loss to tax evasion in small companies only partly declaring their income then the VAT loss would be £2.9 billion and the PAYE loss would be £6.9 billion. This would give rise to an overall loss to this group of companies of £11.1 billion – or almost exactly half the overall loss that this report is still seeking to allocate. This would imply an average loss per company declaring trading income of £10,000 given that approximately 1.1 million submit tax returns saying they are trading each year. Overall, and given that this is an average that embraces companies that will be turning over sums of up to £1 million or more a year, this seems entirely reasonable.

That then means that 400,000 shadow companies must account for the missing remaining £11 billion of tax, which works out at an average of about £27,500 of tax each. Instinctively this might seem high, but there are a number of factors to consider.

Firstly, most of the loss is VAT, income tax and national insurance and in combination these can amount to more than 50 per cent of evaded income, as has been noted earlier in this chapter, even if that might not be the case if they are accounted for legally.

Secondly, this means that the amount of gross income on which evasion is occurring may be little more than £60,000 in each company – and even if lower rates of income tax were due the gross sum involved may be less, on average, than the VAT registration threshold.

Thirdly, this does not mean VAT is not involved: averages are just that and some companies may have very high turnovers indeed.

Fourthly, when considering this reaction it must be recalled that this loss is not necessarily down to a single individuals in each case, although it could be. The evasion may well also relate to the payment of cash in hand wages, which is why it is highly likely considerable PAYE fraud is a part of this process.

Perhaps as significantly, VAT data (Table 2.7 of the VAT Factbook) makes clear that of the companies that are VAT registered (which is by no means all of them, of course) more than 650,000 trade with income up to the VAT threshold and another 350,000 or more, on average trade between that level and £150,000 of turnover. In other words, if there are shadow companies in the UK economy the indicated likely level of loss arising and anticipated unreported turnover is exactly what might be expected. The estimate is, on other words, entirely plausible.

#### **g. Final thoughts**

There is, almost invariably, suspicion when it is suggested that what seem like enormous sums are unaccounted for within GDP. £100 billion of missing turnover is, undoubtedly, an enormous sum. But to put it in context, the Office for National Statistics is revising the way that UK GDP is calculated during 2014 and as the Financial Times has reported<sup>lxix</sup> the change

might add between 2.5 per cent and 5 per cent to the level of GDP, adding £40bn to £75bn to the total.

When reporting this ONS officials also highlighted that their preliminary measures of spending in 2012 were much stronger than the existing national accounts suggest, raising the possibility of a large upward revision to 2012 growth. The VAT gap is based on these estimates of spending: what this change clearly indicates is that UK measures of the VAT gap are bound to rise. As the Financial Times reported:

*One possibility for a rise in spending not showing up in income, officials said, was a rise in the grey economy with the growing numbers of self-employed doing more work for cash. The suggestion comes as new research by Morgan Stanley suggested a rise in cash used in the economy was a sign of a growing informal economy and tax evasion.*

*Charles Goodhart, an adviser to Morgan Stanley and former Bank of England chief economist, said rises in VAT rates made it “almost certain that the grey economy has expanded at a faster rate than have official recorded data”.*

What now seems possible is that the findings on missing income suggested in this research will be reflected in UK national statistics in the near future.

#### **h. Conclusions to this chapter**

We do not know exactly how much of the tax gap is lost to the UK's shadow companies but it seems very unlikely to be less than the £11 billion suggested here. That is because, first of all HMRC's own VAT data requires that the tax gap be much bigger than they report and because there are a number of reasons why shadow companies are ideal for hiding illicit trading in the UK.

Firstly that's because such companies can be operated entirely anonymously with the person controlling them hiding behind nominee directors and shareholders who need not be in the UK.

Secondly, if no information is ever supplied by these companies to HMRC then they can be struck off the Register of Companies without question as the data on the number of HMRC objections to striking off applications proves.

Thirdly, this is encouraged by the fact that Companies House almost invariably does not prosecute the officers of companies that fail to file legally required returns.

And, fourthly, whilst HMRC has the power to penalise companies for not submitting returns the vast majority of such penalties are never collected. Since they are not the personal liabilities of the directors of the companies but due by the company itself these debts are

written off when the company is struck off and there is, as a result, little incentive to comply with the law.

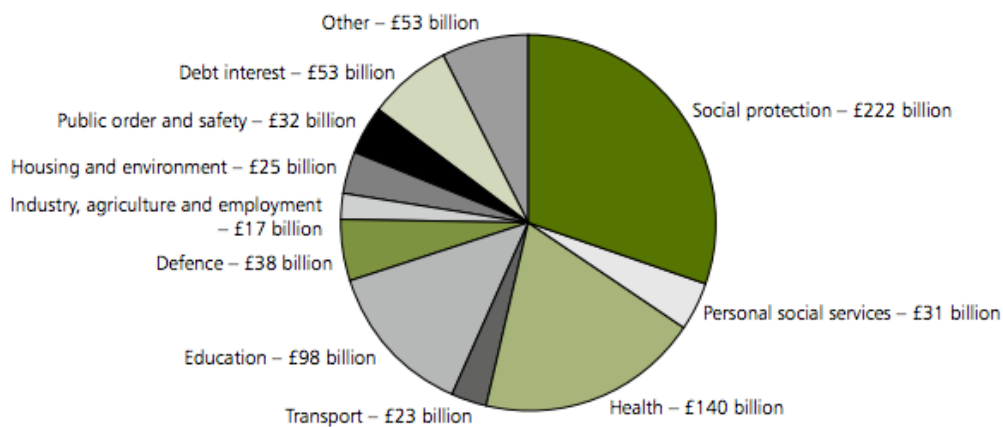
In other words, these companies can be used almost undetected to trade for a period, and then be discarded with a new operation started straight away without interruption to the flow of illicit and unrecorded income. It is simply too easy to arrange this to believe that this is not happening on a significant scale in the UK economy, using limited companies that can be acquired online for less than £50 without any signature being required, seven days a week.

### i. What does £47bn of tax lost represent?

The report suggests that maybe £40 bn of tax was lost as a result of unrecorded trading income in 2011/12, but that this sum may now be closer to £47bn because of inflation, GDP growth and forecast increases in the VAT gap.

The collection of £4ybn of additional tax would have an enormous impact on the UK. The 2014 budget statement suggested that UK state spending in 2014/15 would be as follows.<sup>lxx</sup>

**Chart 1: Government spending 2014-15**



Source: Office for Budget Responsibility, 2014-15 estimates. Allocations to functions are based on HM Treasury analysis.

**Figure 30**

**Source, as noted above**

What this implies is that the £47bn of tax currently lost as a result of the UK's unrecorded sales income could pay for almost the entire UK housing, environment and transport budget. Or it could pay for all personal social services and industry, agriculture and employment and still have money left over.

Looking in more detail<sup>lxxi</sup>, it would pay for all but £6bn of the cost of running the UK's schools. Alternatively, it could pay the £17bn costs of housing benefit, £7bn of income support and £13bn of disability living allowance and have money left over.

Or it could fund more than the entire central government capital expenditure investment programme<sup>lxxii</sup>.

It is also enough to halve the deficit and transform UK economic policy and so its economic outlook.

This, then, is enough money to transform lives. That is why this is money worth having, if only we could lay our hands on it. The question to ask then is whether or not it is possible to find this money.

## 7. What can be done about the UK's shadow companies?

### a. Objectives for this chapter

The previous chapter has:

- Suggested the gains that might arise if the UK could recover the missing £47 billion of tax lost now likely to result from its shadow economy based on updating the £40 billion estimate for 2011/12, a significant part of which is hidden by the UK's shadow companies.

This chapter will:

- Suggest ways in which at least some of that money might be recovered.

### b. Being realistic: we cannot get everything

The first thing that has to be said when considering this issue is that it is important to be realistic about what can be done to tackle the problems this report has highlighted. The UK has a substantial shadow economy but it is smaller than that of many states.<sup>lxxiii</sup> France, Germany and even Norway have bigger shadow economies than the UK. Switzerland and the USA on the other hand have shadow economies only two-thirds (approximately) the size of that the UK's. Although it is undoubtedly true that HMRC is under-resourced and that fact may indicate weak leadership, it does not suffer from many of the problems frequently found in such organisations, such as corruption, and nor is the UK an utterly lawless country. But, we could do better. We can never eliminate the whole tax gap but the aim has to be to close it down as much as possible. This is an achievable goal. It is entirely realistic to think that many billions of pounds could be raised by tackling the tax gap and one way of doing that is to tackle the problem of shadow companies.

### c. Sticks are not the only weapon against tax abuse

Ultimately all tax is paid by consent. If in a democracy taxpayers decide they do not want to pay tax they can vote those parties that propose to impose taxes out of office. There is little sign of this happening. As such it is fair to conclude that a lot of people pay tax by consent and a great many others can be persuaded to comply with the requirements of the tax system. At the same time, as noted in the previous section, it is highly likely that some will never pay the tax demanded of them.

The art of designing a good tax system is to generate the maximum voluntary compliance on the part of taxpayers while using as little pressure as possible on those who have to be coerced to extract maximum cash at least cost. The best way to achieve this is to persuade as many taxpayers as possible that co-operation with the tax authorities is desirable by

making them believe that voluntary disclosure of the sums that they owe is in their own best interests.

#### **d. Tackling the problem – identifying who is trading**

There is an obvious way to tackle the problem of identifying which companies are really trading in the UK.

Based on US experience there is very strong evidence that if an income stream is not automatically reported to a tax authority then the chance that it will be under-declared on a tax return increases considerably. So, for example, it has been found by the US Treasury (whose data HMRC uses for tax gap estimation purposes) that business income in the USA is under-reported by 43 per cent on average and self employed income by maybe 52 per cent.<sup>lxxiv</sup> However, wages and salaries subject to tax deduction in the US – which are subject to automatic notification of the sum paid to the US tax authorities, as they are to HMRC – are correctly reported 99 per cent of the time on tax returns. US data on corporate income taxes suggests that large companies under-declare income by 17 per cent on average and smaller companies by 29 per cent.

What this data suggests is that the fact that a company is trading must be reported by third parties to HM Revenue & Customs. This would then give HMRC the chance to ask for corporation tax returns from as many as possible of the companies likely to owe tax, and that has to be the reasonable aim of the UK tax system.

There is now a new way that is available to achieve this goal. This is to bring the idea of automatic information exchange, now widely expected of tax havens, into UK domestic law. Under automatic information exchange rules between two states each has to provide the other with information on the income persons from the other state earn within their jurisdiction. What this actually means, of course, is that they have to first of all collect this information from those operating in their financial services industry. That requires that their banks, in particular, must identify who are the beneficial owners of the companies to whom they provide services, and that those banks must then advise the country's central authorities of this information if it needs to be supplied to another state with whom there is an automatic information exchange agreement. So, for example, the Cayman Islands now has to obtain information from its banks and other financial services bodies on which people from the UK have an interest in Cayman accounts and then supply that data to the UK.

This might sound onerous but, firstly, this is now becoming an internationally accepted norm, and because the UK has signed up to provide data of this sort on the basis of automatic information exchange to the USA, all UK banks and other financial services providers now have to secure this information for all accounts they maintain. As such the obligation to obtain all this information already exists since US controlled accounts in the UK cannot be identified unless data on the beneficial ownership of all companies is collected by all banks and other financial services providers for all customers to whom they provide

services. Secondly, although it is little known, UK banks have for many years been required to supply the details of all interest earned by an individual in the UK to HMRC annually. This is why tax compliance on this particular source of income is thought to be high. As a result banks are familiar with this need to supply data to tax authorities to beat tax evasion.

What we now very clearly need in that case is that banks be required to disclose the information that they will now hold on who owns UK companies to the UK's tax authorities and to Companies House, just as they now have to disclose information on US residents holding interests in UK companies to HMRC for supply to the USA. The important point is though that banks will, when supplying the data, both by implication and explicitly have to disclose that the company they are reporting on has a bank account. That means HMRC will by default know all companies that are likely to be trading (unless fraudsters choose to have bank accounts outside the UK) because it is only companies with bank accounts that are likely to owe tax. As such, and again by default, HMRC will know for the first time exactly which companies they need to demand tax returns from, and will as a result know that they will not be wasting anyone's time when doing so.

#### **e. Tackling the problem – identifying the beneficial owners of companies**

This suggested requirement that banks should supply data on the beneficial ownership of companies would then create a quality control check on another important new measure to be introduced in 2014. This new planned requirement is that companies disclose their beneficial as well as their legal ownership to Companies House. This is a development pioneered by Prime Minister David Cameron at the G8 in 2013 and is intended to ensure that the real owners of companies cannot hide behind nominee names and so hide their involvement in a company's affairs.

The purpose for requiring this data from companies is clear: personal responsibility for complying with the legal requirement that a company declare its income and pay its tax has to be established. This cannot be done if it is not known who is actually controlling the operations of a company, which happens all too often at present.

These two processes i.e. requiring that the banks advise Companies House and HMRC on which companies are trading and who their beneficial owners are and the requirement that companies themselves also disclose information on beneficial ownership are vital first stages in transforming the available data on which companies are really trading in the UK that might ensure that tax returns are demanded from the right companies in future and that payment of tax owing is also made.

The next vital stage is, however, that this data is acted upon. What is needed is that HMRC must have a legal obligation imposed upon it to request a tax return from any company if there is evidence of it having a relationship with any financial services provider.

The power of Companies House to strike a company off the Register of Companies also needs to be curtailed so that no company can be dissolved if Companies House has received information from a financial services provider that it has at some time maintained a bank account and if accounts for that period have not been provided. This will necessarily mean that applications for striking off will be deferred in many cases until data can be verified on this issue, and that is as it should be. The assumption that accounts should be supplied should prevail as the norm.

#### **f. Tackling the problem – giving HMRC the power to collect the tax owing**

In combination these provisions impose a duty of good governance on both HMRC and Companies House. At the same time they also, as importantly, impose that duty on the small business community. However, because there will, inevitably, be those companies who try not to comply additional powers to secure information from companies that do not submit accounts or tax returns must be given to HMRC to chase data in that situation. It must not be possible that directors and significant beneficial owners of a company can hope to avoid tax liability by simply failing to submit information required by law.

These suggested additional powers should provide that if a company fails to submit a tax return within three months of its submission deadline then HMRC should be given the right to go to any bank holding an account for the company and request all data it holds on the company, including bank statements. HMRC should then be given the right to use this information to raise estimated tax assessments on the company for any reasonable sum that HMRC thinks might be owing and if that happens then these liabilities should be the joint and several liability not just of the company but all its directors and all beneficial owners holding more than 25 per cent of the shares in the company as well. Those people will, of course, have the right of appeal against the tax due, but would have to then prove that a lower sum was due.

This is essential now; for too long HMRC has not had the power to investigate missing companies and have resorted to having them struck off instead of taking action to recover tax that might be owing. This has meant limited companies have become the trading medium of choice for those seeking to avoid their obligations to pay tax. The loss arising as a result is now far too high and imposes far too great a burden on society. These changes in the law redress the balance to ensure that tax can be recovered from those who owe it.

#### **g. Tackling the problem – providing the resources to enforce the law**

Realistically it has to be noted that there will, of course, be a cost to pursuing these missing billions in the ways noted. However, the additional cost for banks supplying data would be insignificant and the cost of additional staff at HMRC and Companies House is bound to be outweighed by the considerable additional tax raised. In this context it is important to note that HMRC costs a little under £4bn a year to run.<sup>lxxv</sup>

## Appendix 1

### Reasons for the increased popularity of the limited company

As is noted in Chapter 3, there are three significant reasons for the increased popularity of the limited company in the UK in the 21<sup>st</sup> century. Each is explored in more detail in this appendix.

- **The abolition of the small company audit**

All UK companies are required by law to prepare annual accounts in a format laid down by the UK Companies Acts (the most recent being the Companies Act 2006).

The 1967 Companies Act (now replaced by the 2006 Act) for the first time introduced a requirement that all companies must file their annual accounts at Companies House: until then private companies enjoyed an exemption from filing. In addition, that Act required that all accounts of private limited companies be audited by an independent qualified person. This requirement arose as a result of a recommendation of a committee in the early 1960s that had emphasized the value to credit insurers of reliable information on the trading of all companies being available on public record. That benefit was not hard to see; if reliable information on the creditworthiness of a company with which a person planned to trade was available then the risk of suffering a bad debt as a result of that trade was very obviously reduced. That had to be to the benefit of society as a whole because the efficiency and reliability of markets would be enhanced as a result.

The benefit of that information placed on public record was substantially reduced from 1981 when, as a result of the implementation of the European Commission Fourth Company Law Directive, the then government took advantage of the exemptions made available throughout the EU allowing small and medium-sized companies to file short-form or abbreviated accounts. Despite the fact that this meant that these companies filed either no, or very limited, profit and loss accounts and many fewer notes than in a full set of accounts, it remained a legal requirement that they publish full audited accounts for the benefit of their members. In other words, there was no saving in cost for the companies as a result of this change because they actually had to prepare both full and abbreviated accounts, with the latter merely meaning they could publish less information on public record. The logic of this has always been hard to understand, but it should be stressed that the costs involved were not, necessarily, onerous. Some small companies bought their audit services for only a few hundred pounds a year.

In 1993, following implementation of the European Commission Eighth Company Law Directive, there was a further change in UK company law as a result of which very small private companies (those with a turnover of £90,000 or less) no longer needed their accounts audited while private companies with a turnover of between £90,000 and £350,000 were required to have an accountant report on their accounts, but those

accountants did not need to undertake an audit, a situation that lasted for just four years, after which the turnover limit below which an audit was not required was increased to £350,000.

This change in audit regulation undoubtedly increased the attractiveness of small limited companies to some businesses because most would have enjoyed cost saving as a result of not having to have their accounts audited. It is, however, stressed that the company still had to prepare full accounts for presentation to its members; it was just that they did not now need to be audited.

In 1999 this issue of an audit requirement was considered again as a result of further changes in European Union law. As a result of the 1999 review<sup>lxxvi</sup> the thresholds at which an audit was required changed again, being substantially increased in 2000 to £1m,<sup>lxxvii</sup> and then again in 2004 to the EU maximum of £5.6m, a figure increased again in 2008 to £6.5m.<sup>lxxviii and lxxix</sup>

The result was that in a little over a decade the requirement that most companies have their accounts audited, or even examined by an independent third party, was virtually abolished in the UK. According to the 2012-13 statistical data on company registration activities published by the Department for Business, Innovation and Skills<sup>lxxx</sup> (table F2) only seven per cent of all companies filing accounts in that year might have required them to be audited. The number of audit exempt companies has increased steadily since 2004.

This is a matter of considerable significance. Whereas in 1993 every company had to have its accounts subject to independent review by a qualified person by 2008 the vast majority did not. It cannot be said that this directly increased the number of companies incorporated, but it must have increased the attractiveness of using a limited company for some, and most especially those with little regard for regulatory obligations. At the same time an essential third party regulatory control on small business activity and regulatory compliance in the UK almost entirely disappeared. The wise counsel of the 1960s on the value to society of having high quality financial information verified by third parties has been forgotten over the intervening fifty years.

- **The cost of incorporation of companies**

Quite remarkably the annual cost of maintaining a company with the Registrar of Companies has remained extraordinarily low for a very long time. The maximum fee payable annually was for many years £30, this being the sum due when filing an annual return form on paper for a limited company. This was increased in 2012 to £40 but at the same time the fee for filing this form on line - which represents the only annual cost payable to maintain a company in the UK – was reduced to £13.

Similarly low charges are found for other Companies House services.<sup>lxxxi</sup> For example, the fee due on incorporation of a company is just £40, but when done online that sum is reduced to £13.

These charges are now so insignificant that they represent no obstacle to the operation of a limited company at all.

- **Tax incentives to incorporate**

Since the introduction of corporation tax (as distinct from income tax) on the profits of UK resident companies in 1965 there has been a deliberate policy in force that has meant that small companies (as measured solely by the amount of taxable profit earned in a year) should pay tax at a lower rate on those profits than larger companies pay on their larger earnings. The nominal rate of tax paid by small companies has fallen over time, currently being 20 per cent for small companies. The large company tax rate, which was 28 per cent in 2010, is now falling steadily<sup>lxxxii</sup> and will be 21 per cent in 2014.

This convergence of tax rates does not, however, mean that there has been a change to the situation that has been widely recognised since the late 1980s where many small businesses can obtain a tax advantage by operating as a limited company when compared to the situation of the self-employed or employed on similar levels of income. This arises in particular with regard to securing a reduction in the overall national insurance charge that the company and its owners / directors pay (on which point there is more, below).

This tax advantage, coupled to successive labour market reforms promoted since the 1980s, and especially since the time of the recession at the close of that decade and the resulting increase in the supply of labour as a sub-contracted service in some industries (and especially the IT sector), gave rise to a rapid increase in the number of companies in use for the operation of small businesses owned by a new contracting, consulting, managerial, professional and technical class of personnel.

This trend continued into the era of the dot.com boom of the 1990s, while further labour market liberalisation since then and the post 2008 recession has now forced many into involuntary self-employment on a labour only supply basis. Employing people on this contractual basis does, however, put many 'employing' companies at risk of it being suggested that they should operate Pay As You Earn (PAYE) income taxation when paying such staff. This suggestion is avoided if the labour only contract supply from the 'self-employed' person is delivered via a limited company of which that 'self-employed' person is then technically an employee.

The result has been that in this labour only contracting market many 'employers' now insist that those working for them use limited companies to supply their services, or do so via agencies that act as intermediaries to facilitate such arrangements. It is probably this single fact that has led more than anything else to the significant increase in the number of incorporations of companies since the 1990s.

It is however tax, and tax alone, that explains the boost in incorporation that occurred in 2002. Quite unexpectedly Gordon Brown's 2002 budget introduced a new starting rate of

corporation tax of zero per cent on the first £10,000 of taxable profit a small company earned, with the rate over the next £40,000 of taxable profit increasing to 19 per cent, with that rate then being charged on any additional profits of up to £300,000. This led to a significant increase in the number of companies incorporated as businesses that had previously operated on a self-employed basis. That was because they could as result save well over £1,000 in tax in many cases by doing so. As a result the number of new companies incorporated leapt from 2002 onwards. In the year to March 2003 alone the number of new incorporations increased by 44.5 per cent with an additional 100,000 companies likely to have been incorporated as a result in that year alone, with the trend becoming even stronger the following year.

The government rapidly realised its error of judgment in offering this tax incentive, whose popularity it appeared not to have anticipated, and began to withdraw it from 2004 onwards, eliminating it entirely from 2006,. But the habit of incorporation had received a significant boost. Although the rate of incorporations declined by fourteen per cent in 2004-05, almost certainly as a result of the partial withdrawal of the tax incentive at that time, the rate recovered the year after, only declining again with the onset of broader economic problems in 2007-08.

Despite that initial fall in the incorporation rate as the 2008 recession hit, recovery was not long in coming. Labour-only supply of contract work through limited companies became even more commonplace once the recession hit, and limited companies remained the essential tool for making such arrangements.

In addition, many of the tax advantages offered by using limited companies to earn income which could then be paid out by way of a dividend to the owner/director, and maybe even members of their family, have survived, especially after HMRC lost a court case<sup>lxxxiii</sup> challenging such arrangements in 2007. It is quite possible for a person earning approximately £40,000 a year through a company to save well over 10 per cent of that sum in tax and national insurance by using a company and paying themselves dividends when compared to an employee on apparently similar earnings and not much less than 10 per cent of that sum when compared to a self-employed person. In that case the reason for incorporation when the cost of doing so is so low and the accounting obligations arising are relatively small is fairly obvious to most self-employed people earning more than a modest sum each year. This might also explain why the average earnings of the remaining self-employed people in this country appear to be falling<sup>lxxxiv</sup> since those with any significant earnings incorporate as it pays them to do so.

## Appendix 2

### About the author

Richard Murphy (56) is a chartered accountant and economist. A graduate in economics and accountancy from Southampton University he was articled to Peat Marwick Mitchell & Co in London. He subsequently founded a firm of accountants in London. In parallel with his practice career Richard was chairman, chief executive or finance director of more than ten SMEs.

Since 2003 Richard has been increasingly involved in economic and taxation policy issues. He was a founder of the Tax Justice Network and is currently director of Tax Research LLP. He also runs an accountancy practice.

Richard Murphy has been responsible for introducing many new issues into debate on tax policy. In particular he created the entirely new accounting concept of country-by-country reporting that has now been partially adopted by the European Union and will be for international taxation by Organisation for Economic Co-operation and Development, the latter at the behest of the G8 and G20.

Richard is also widely considered to have created the UK debate on the tax gap which began with the publication in 2008 of his report entitled 'The Missing Billions' by the TUC. Richard researched the current EU estimate of the European tax gap.

As principal researcher of the Tax Justice Network from its inception until 2009 Richard helped put the tax haven issue on the international agenda. He created the Financial Secrecy Index for that organisation and in the process defined the term 'secrecy jurisdiction', which is the main technical term now used to describe what are colloquially known as tax havens.

Richard has been a visiting fellow at Portsmouth University Business School, the Centre for Global Political Economy at the University of Sussex and at the Tax Research Institute, University of Nottingham.

He is a co-author of 'Tax Havens: How Globalization Really Works', Cornell University Press, 2009 and author of 'The Courageous State', Searching Finance, 2011 and 'Over Here and Under Taxed', Vintage Books, 2013.

In October 2012 the Association of International Accountants gave Richard their award for an Outstanding Contribution to the Accountancy Profession.

In December 2013 Richard was ranked as the seventh most influential person in international taxation in International Tax Review's Global Tax 50 of the most significant participants in worldwide tax.

## Endnotes

- <sup>i</sup> <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf>
- <sup>ii</sup> <http://www.taxresearch.org.uk/Documents/500000Final.pdf>
- <sup>iii</sup> This is, admittedly, and rather strangely defined by HMRC as a company making profits of less than £350,000 a year
- <sup>iv</sup> Data from the Institute for Fiscal Studies for 2011-12, the most recent year available <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf>
- <sup>iv</sup> <http://www.taxresearch.org.uk/Documents/500000Final.pdf> <http://www.ifs.org.uk/bns/bn13.pdf>
- <sup>v</sup> Data on live births from [http://www.ons.gov.uk/ons/dcp171778\\_317196.pdf](http://www.ons.gov.uk/ons/dcp171778_317196.pdf)
- <sup>vi</sup> For example, see this note on starting a company in Germany from the World Bank <http://www.doingbusiness.org/data/exploreeconomies/germany/starting-a-business/>
- <sup>vii</sup> Forming a company in Norway, for example costs, approximately £1,000. See <http://www.doingbusiness.org/data/exploreeconomies/norway/starting-a-business>
- <sup>viii</sup> For example, see [http://www.formationshouse.com/manage\\_company.htm](http://www.formationshouse.com/manage_company.htm)
- <sup>ix</sup> [https://www.theformationscompany.com/app/?gclid=CNW22YrdpbwCFQ\\_HtAoduB4AFg](https://www.theformationscompany.com/app/?gclid=CNW22YrdpbwCFQ_HtAoduB4AFg)
- <sup>x</sup> <http://www.eduardomorgan.com/blog/wp-content/uploads/2010/12/Sharman-Fall-2010.pdf>
- <sup>xi</sup> See for example here <http://www.completeformations.co.uk/index.html>
- <sup>xii</sup> This was verified by incorporating a company in this way during the course of this research
- <sup>xiii</sup> <http://www.hmrc.gov.uk/vat/forms-rates/rates/rates-thresholds.htm#2>
- <sup>xiv</sup> All tax data based on Budget 2013 information published by HM Treasury
- <sup>xv</sup> For example, [http://www.companieshouse.gov.uk/about/corporateDocuments/AnnualReportAccounts2012\\_13.pdf](http://www.companieshouse.gov.uk/about/corporateDocuments/AnnualReportAccounts2012_13.pdf)
- <sup>xvi</sup> <http://www.bbc.co.uk/news/uk-wales-south-west-wales-12647065>
- <sup>xvii</sup> Noted here <http://www.taxresearch.org.uk/Documents/PCSTaxGap.pdf>
- <sup>xviii</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/210244/9549-TSO-HMRC\\_RA\\_ACCESSIBLE.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/210244/9549-TSO-HMRC_RA_ACCESSIBLE.pdf)
- <sup>xix</sup> [http://www.companieshouse.gov.uk/about/corporateDocuments/AnnualReportAccounts2012\\_13.pdf](http://www.companieshouse.gov.uk/about/corporateDocuments/AnnualReportAccounts2012_13.pdf)
- <sup>xx</sup> <http://www.redtapechallenge.cabinetoffice.gov.uk/2014/01/27-01-14-3000-regulations-to-be-reformed-or-slashed/>
- <sup>xxi</sup> <http://www.bbc.co.uk/news/business-25903681>
- <sup>xxii</sup> <http://www.companieshouse.gov.uk/infoAndGuide/faq/strikingOff.shtml>
- <sup>xxiii</sup> Parliamentary answer referred to on page 65, here <http://www.taxresearch.org.uk/Documents/500000Final.pdf>
- <sup>xxiv</sup> [http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2012\\_2013.pdf](http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2012_2013.pdf) page 24
- <sup>xxv</sup> In fairness the Companies House report says “Prosecution Statistics are not available as negotiations are ongoing with the Prosecutor Fiscal’s office” but the chance that Companies House does not know how many prosecutions it has been involved in seems remote and the conclusion drawn that there are none is what they publicly declare in their report
- <sup>xxvi</sup> <http://www.theyworkforyou.com/wrans/?id=2014-01-14a.182426.h>
- <sup>xxvii</sup> [http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2012\\_2013.pdf](http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2012_2013.pdf) page 13
- <sup>xxviii</sup> The questions and answers referred to are being published as a separate note at the same time as this report
- <sup>xxix</sup> <http://www.theyworkforyou.com/wrans/?id=2013-11-07a.174027.h>
- <sup>xxx</sup> <http://www.hmrc.gov.uk/ct/getting-started/deadlines.htm>
- <sup>xxxi</sup> See <http://www.companieshouse.gov.uk/about/pdf/gba10.pdf>
- <sup>xxxii</sup> *ibid*
- <sup>xxxiii</sup> <http://www.companieshouse.gov.uk/forms/generalForms/DCA.pdf>
- <sup>xxxiv</sup> <http://www.globalwitness.org/sites/default/files/library/KyrgyzstanReportGrave%20Secrecy.pdf>
- <sup>xxxv</sup> <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/666/131028.htm>
- <sup>xxxvi</sup> [http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2012\\_2013.pdf](http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2012_2013.pdf) page 10
- <sup>xxxvii</sup> <http://www.hmrc.gov.uk/statistics/ct-receipts/corporation-tax-statistics.pdf>
- <sup>xxxviii</sup> <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf>
- <sup>xxxix</sup> <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-annex2013.pdf>
- <sup>xl</sup> [https://www.uktradeinfo.com/statistics/statistical%20factsheets/vat\\_factsheet\\_2013.xls](https://www.uktradeinfo.com/statistics/statistical%20factsheets/vat_factsheet_2013.xls)
- <sup>xli</sup> <http://www.bis.gov.uk/assets/biscore/statistics/docs/b/12-92-bpe-2012-stats-release.pdf> and <https://www.gov.uk/government/publications/business-population-estimates-2013> and <https://www.gov.uk/government/publications/bis-business-population-estimates>
- <sup>xlii</sup> <http://www.ons.gov.uk/ons/guide-method/method-quality/specific/labour-market/articles-and-reports/revisions-to-workforce-jobs-april-2013.pdf>
- <sup>xliii</sup> <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/666/131028.htm>

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<sup>xliv</sup> <http://www.socialistsanddemocrats.eu/publications/closing-european-tax-gap-report-group-progressive-alliance-socialists-democrats>

See also: <http://www.europarl.europa.eu/news/en/news-room/content/20130521IPR08701/html/MEPs-call-for-EU-wide-action-to-collect-tax-lost-to-fraud-and-evasion> in which it is noted that the EU Parliament endorsed the estimate and [http://europa.eu/rapid/press-release\\_SPEECH-13-434\\_en.htm](http://europa.eu/rapid/press-release_SPEECH-13-434_en.htm) in which President Barossa of the European Commission quotes this estimate.

<sup>xlv</sup> <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf>

<sup>xlvi</sup> [http://ec.europa.eu/taxation\\_customs/resources/documents/common/publications/studies/vat-gap.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/vat-gap.pdf)

<sup>xlvii</sup> <http://www.imf.org/external/pubs/ft/scr/2013/cr13314.pdf>

<sup>xlviii</sup> <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2009.pdf>

<sup>lix</sup> [http://ec.europa.eu/taxation\\_customs/resources/documents/common/publications/studies/vat-gap.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/vat-gap.pdf)

<sup>l</sup> The EU study says concerning the UK HMRC data “Published estimates are somewhat lower than the ones in this report (by about 2 percentage point, with the exception of a larger difference in 2011), but have been reconciled through a number of factors: (i) the use of fiscal vs calendar year; (ii) netting out of litigation repayments; (iii) slight differences in data revisions and calculation of rates applicable to product groupings”. In other words, the EU think HMRC underestimate the VAT tax gap.

<sup>li</sup> [http://ec.europa.eu/taxation\\_customs/resources/documents/common/publications/studies/vat-gap.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/vat-gap.pdf) page 36

<sup>lii</sup> The recipient could not claim this was a dividend as no documentation to declare it as one will have been prepared and loans to directors are almost invariably subject to PAYE taxation so this excuse cannot be used either.

<sup>liii</sup>

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221885/budget2013\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf) page 102

<sup>liv</sup>

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221885/budget2013\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf) pages 101 and 102

<sup>lv</sup> [http://www.econ.jku.at/members/Schneider/files/publications/2012/TaxEvasion\\_buehn.pdf](http://www.econ.jku.at/members/Schneider/files/publications/2012/TaxEvasion_buehn.pdf) page 11

<sup>lvi</sup>

[http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=478060&piPK=64165421&menuPK=64166093&entityID=000158349\\_20101014160704](http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=478060&piPK=64165421&menuPK=64166093&entityID=000158349_20101014160704)

<sup>lvii</sup> <sup>ibid</sup>

<sup>lviii</sup>

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/263942/35062\\_Autumn\\_State\\_Ment\\_2013.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263942/35062_Autumn_State_Ment_2013.pdf) page 111

<sup>lix</sup>

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221885/budget2013\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf) page 101

<sup>lx</sup> <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf>

<sup>lxi</sup> <http://www.taxresearch.org.uk/Documents/SEI2013.pdf>

<sup>lxii</sup> <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf> page 38

<sup>lxiii</sup> <http://www.theguardian.com/news/datablog/2013/dec/12/uk-median-weekly-pay-is-517-but-who-earns-that>

<sup>lxiv</sup> <http://www.taxresearch.org.uk/Documents/SEI2013.pdf>

<sup>lxv</sup> <http://www.hmrc.gov.uk/statistics/tax-gaps/mtg-2013.pdf> page 54

<sup>lxvi</sup> <http://www.hmrc.gov.uk/statistics/ct-receipts/table11-6.pdf>

<sup>lxvii</sup> VAT Fact Sheet 2012-13 table 2.9

<sup>lxviii</sup>

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/304364/20140410\\_Mar\\_v0.1.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/304364/20140410_Mar_v0.1.pdf)

<sup>lxix</sup> <http://www.ft.com/cms/s/0/457b9332-be6c-11e3-b44a-00144feabdc0.html#ixzz2znLIF8Bd>

<sup>lxx</sup>

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221885/budget2013\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf)

<sup>lxxi</sup> <http://www.theguardian.com/news/datablog/2012/dec/04/government-spending-department-2011-12>

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[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221885/budget2013\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf) Page 103

lxxiii [http://www.econ.jku.at/members/Schneider/files/publications/2012/TaxEvasion\\_buehn.pdf](http://www.econ.jku.at/members/Schneider/files/publications/2012/TaxEvasion_buehn.pdf)

lxxiv Data reported here <http://www.bus.umich.edu/otpr/DITN%20091308.pdf>

lxxv [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/210244/9549-TSO-HMRC\\_RA\\_ACCESSIBLE.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/210244/9549-TSO-HMRC_RA_ACCESSIBLE.pdf)

lxxvi *ibid*

lxxvii Institute of Chartered Accountants in England and Wales, 2006, "Audit-exempt companies - Beyond the threshold" an Issues paper

lxxviii [http://uk.accaglobal.com/uk/members/technical/financial\\_reporting/legislation\\_standards/SI393](http://uk.accaglobal.com/uk/members/technical/financial_reporting/legislation_standards/SI393)

lxxix <https://www.gov.uk/audit-exemptions-for-private-limited-companies>

lxxx [http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2012\\_2013.pdf](http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2012_2013.pdf)

lxxxi <http://www.companieshouse.gov.uk/toolsToHelp/ourPrices.shtml>

lxxxii <http://www.hmrc.gov.uk/rates/corp.htm>

lxxxiii <http://www.accountancyage.com/aa/special/1761868/arctic-systems-timeline-background>

lxxxiv <http://www.taxresearch.org.uk/Documents/SEI2013.pdf>