



House of Commons  
Committee of Public Accounts

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# HM Customs and Excise Standard Report

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Thirty-second Report of  
Session 2003–04

*Report, together with formal minutes,  
oral and written evidence*

*Ordered by The House of Commons  
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## The Committee of Public Accounts

The Committee of Public Accounts is appointed by the House of Commons to examine "the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit" (Standing Order No 148).

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Rt Hon Alan Williams MP (*Labour, Swansea West*)

The following were also members of the Committee during the period of this inquiry.

Mrs Cheryl Gillan MP (*Conservative, Chesham and Amersham*)  
Mr George Osborne MP (*Conservative, Tatton*)

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Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via [www.parliament.uk](http://www.parliament.uk).

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The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at [http://www.parliament.uk/parliamentary\\_committees/committee\\_of\\_public\\_accounts.cfm](http://www.parliament.uk/parliamentary_committees/committee_of_public_accounts.cfm). A list of Reports of the Committee in the present Session is at the back of this volume.

### Committee staff

The current staff of the Committee is Nick Wright (Clerk), Christine Randall (Committee Assistant), Leslie Young (Committee Assistant), and Ronnie Jefferson (Secretary).

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# Summary

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## Introduction

HM Customs & Excise (Customs) collect around £150 billion in VAT, excise and customs duties each year from over 1.7 million business traders.

Section 2 of the Exchequer and Audit Departments Act 1921 requires the Comptroller and Auditor General to examine the accounts of Customs to ascertain:

- that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out; and
- to examine the correctness of sums brought to account; and to report the results to the House of Commons.

On the basis of the Comptroller and Auditor General's Report,<sup>1</sup> the Committee took evidence from Customs on two main issues: their approach to combating the problem of alcohol fraud, and their management of revenue from large traders.

The Comptroller and Audit General reported and the Committee took evidence before the Chancellor of the Exchequer announced in his budget speech on 17 March 2004 that Customs were to merge with the Inland Revenue,<sup>2</sup> and before he confirmed the decision to require bottled spirits sold in the UK market to be tax-stamped from 2006, which was originally announced in the Pre-Budget Report on 10 December 2003.<sup>3</sup>

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1 C&AG's Report, *HM Customs and Excise: Standard Report 2002–03*, HC Deb 17 March 2004 vol 419 c331

2 Budget Statement by the Chancellor of the Exchequer, HC Deb 17 March 2004 vol 419 c331

3 Pre-Budget Report Statement by the Chancellor of the Exchequer, HC Deb 10 December 2003 vol 415 c1066

## Conclusions and recommendations

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- 1. There is significant uncertainty about any estimates of spirits fraud based upon current methodologies and data sources.** The methodologies and data sources used by Customs and the Scotch Whisky Association for estimating spirits fraud levels result in widely different estimates of consumption. Customs should disclose ranges of values to reflect the uncertainty.
- 2. Manufacturers will face significant costs in buying tax stamps and incorporating them into production processes.** Measures were announced in the Budget speech aimed at offsetting additional costs caused by introducing tax stamps.<sup>4</sup> Drawing upon the recently completed Regulatory Impact Assessment, Customs need to identify likely additional costs arising from the introduction of tax stamps and take appropriate steps to mitigate these costs.
- 3. Customs should make better use of existing information from alcohol producers to track suspected illicit products.** Customs could then target resources more effectively at the point where alcohol is diverted in the supply chain. They should also discuss with the trade the effectiveness of current anti-fraud measures and the opportunity for further regulatory or operational improvement.
- 4. Customs' estimates would suggest that there is no beer and wine duty fraud though operational teams have seized non-duty paid beer and wine so fraud is clearly taking place.** Customs should seek to develop alternative methodologies and identify new data sources to produce better estimates.
- 5. Poor communication within Customs has undermined anti-fraud operations and prosecutions.** Customs need to improve communication between their anti-fraud teams throughout the Department to avoid repeating failures in previous operations which have led to the loss of key evidence and the destruction of documentation. Customs also need to improve the sharing of lessons learned from successful operations across the Department to allow these to be taken into account in future anti-fraud activities.
- 6. Customs need a consistent and effective way of evaluating the results of the work of the Large Business Group and the Regional Business Services and the contribution of these groups to departmental targets.** Customs have established the Large Business Group to improve the management of risk and the collection of revenue from large traders. They have improved relations with business and improved the training and professionalism of their own staff, but need to develop more effective measures than are currently available to evaluate the return on their investment in large business work.

# 1 The scale of alcohol fraud and the introduction of tax stamps

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1. Customs collect around £7 billion of revenue each year from excise duty on alcohol products including beer, spirits and wine. Like other goods subject to excise duty, alcohol is vulnerable to fraud, with Customs estimate of losses to the Exchequer being £600 million for 2001–02.<sup>5</sup> The issue of alcohol fraud has been closely scrutinised in recent years, including this Committee's Report in May 2002,<sup>6</sup> the 2001 Roques Report<sup>7</sup> and 2003 Butterfield Inquiry.<sup>8</sup>

2. Customs informed us that most alcohol fraud involves large-scale criminal gangs diverting alcohol on which duty has been suspended before it reaches its destination.<sup>9</sup> In order to facilitate legitimate trade, and in line with EU rules created to facilitate the single market in 1992, duty is suspended on finished alcohol products until they are released for consumption. The diverted goods are sold on the UK market without the payment of duty, generally through smaller commercial and retail outlets (see **Figure 1**). This type of fraud can take place at any point in the long and complicated alcohol supply chain, without the complicity of the final sales point.

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5 HM Customs and Excise, *Measuring and tackling indirect tax losses*, December 2003

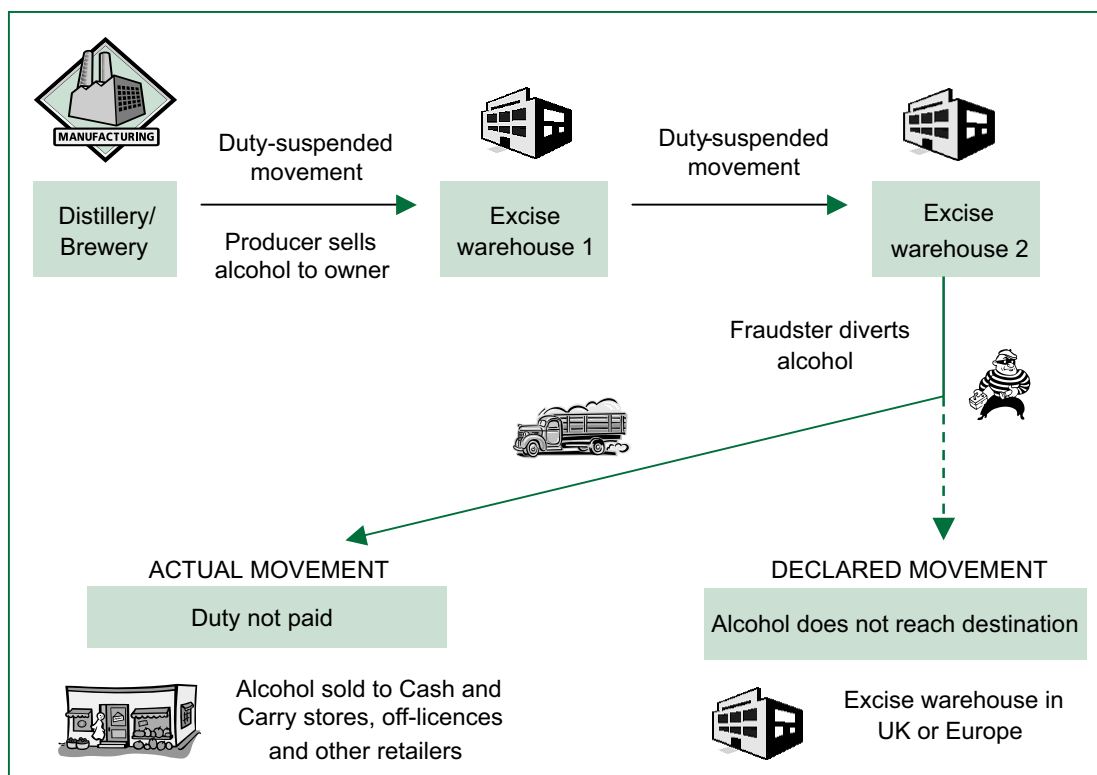
6 35<sup>th</sup> Report from the Committee of Public Accounts, *Losses to the revenue from frauds on alcohol duty* (HC 331, Session 2001–02)

7 John Roques, *The collection of excise duties in HM Customs and Excise*, July 2001

8 Hon Mr Justice Butterfield, *Review of criminal investigations and prosecutions conducted by HM Customs and Excise*, July 2003

9 Qq 20–21

Figure 1: Illustration of excise diversion fraud



Source: National Audit Office & Customs<sup>10</sup>

3. Customs have an evolving programme of measures to combat alcohol fraud within their Alcohol Strategy. In his Pre-Budget Report<sup>11</sup> the Chancellor announced the proposed introduction of tax stamps on all bottled spirits produced in the UK from 2006–07. Tax stamps were recommended in the Roques Report<sup>12</sup> in 2001, but following extensive industry consultation the Government did not introduce them at that time as it considered that the compliance costs were not proportionate to the estimated benefit in reducing fraud. In the light of estimates of a growing level of spirits fraud, however, Customs now believe tax stamps to be justified and estimate that they will reduce fraud by £160 million in the first full year of implementation.<sup>13</sup>

4. Customs have made significant progress in estimating alcohol fraud given that there were no such estimates three years ago. Since then estimates have been published each year with the pre-budget report using a process called “gap analysis”. Customs compare consumption statistics from the Office for National Statistics and the Department for the Environment, Food and Rural Affairs with the quantities on which alcohol revenue is received to estimate the amount of duty lost, as shown in **Figure 2**.

10 C&AG’s Report, Figure 3.4

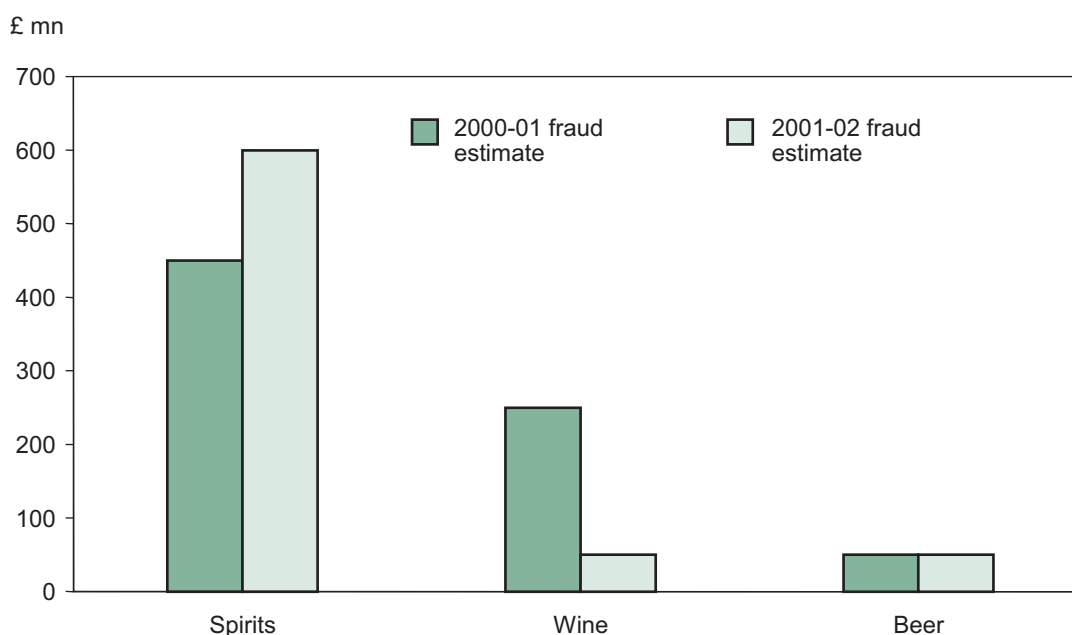
11 HM Treasury, *Tackling alcohol fraud: introduction of Tax Stamps on spirits (Business Brief number 26/2003)*, December 2003

12 Roques Report, para 4.7.6 (Recommendation 27)

13 Q 13



**Figure 2: Estimates of alcohol fraud by Customs**



Source: HM Customs and Excise

5. In practice it has been difficult for Customs to obtain reliable consumption figures for spirits because people tend to under-report their true consumption of alcohol in official surveys. Customs adjust the data for this factor.

6. Representatives of the spirits industry, most notably the Scotch Whisky Association, have raised concerns over the Department's estimates. The Scotch Whisky Association produced much lower estimates of spirits fraud, claiming that it had peaked and was now falling. In view of the wide differences between the estimates of Customs and the industry, we asked the National Audit Office to review them to see whether the underlying assumptions of fraud were prudent and reasonable, and whether the estimates could be reconciled.

7. In his memorandum of 10 March,<sup>14</sup> the Comptroller and Auditor General explained that the disparities in the results of the two methodologies were largely, although not fully, explained by two factors;

- **The source of alcohol consumption data used for the models** – Customs base their estimate of spirits consumption on data from the Expenditure & Food Survey (as well as the Department for the Environment, Food and Rural Affairs' National Food Survey up to 2000–01), whilst the Scotch Whisky Association use the Omnibus survey data (a multi-purpose survey carried out on behalf of public and other non-profit-making bodies) in their models. The Office for National Statistics produce both surveys but use different survey methods to obtain the data. The spirits consumption data in these two surveys diverges from 1996–97 onwards, resulting in significantly different trends in estimates of spirits fraud produced by Customs and the Scotch Whisky Association. The Office for National Statistics plans to investigate and reconcile the survey data.

14 Memorandum by the C&AG, *Estimating the level of spirits fraud*, 10 March 2004

- **Adjustments made to data to take account of under-reporting of alcohol consumption**, which is an inherent feature of alcohol consumption surveys. Customs and the Scotch Whisky Association assume a level of under-reporting in the surveys they use, based on calculations of consumption in 1992–93 when spirits fraud is presumed to be zero. Both estimates of under-reporting fall within the range of 40 to 60% generally made in academic studies in this area, but the assumption increases the uncertainty in the estimates.

8. Using the methodologies of both Customs and the Scotch Whisky Association, the National Audit Office found that the resulting fraud estimates lay within a broad range of uncertainty. This work showed that Customs' estimate of spirits fraud in 2001–02 should be presented as falling between £330 million and £1,080 million. Scotch Whisky Association estimates fell within a range of £10 million to £260 million, though the Office of National Statistics did point to an error in its analysis of underlying data which could affect this estimate.

9. The National Audit Office concluded that the underlying data used and the modelling undertaken by both Customs and the Scotch Whisky Association in estimating spirits fraud were defensible in their own terms. But both methods can hardly be reliable when they result in such widely different estimates. Discussions continue between the Office for National Statistics, Customs and the Scotch Whisky Association to reconcile the differing estimates.

10. We asked if there was potential for closer working with the industry to combat alcohol fraud. For example, each bottle of spirits has unique labelling as part of manufacturers' sophisticated traceability systems that could be accessed by the Department.<sup>15</sup> Customs acknowledged that such information would be useful, but maintained that tax stamps were the only way of providing a quick visible indicator to consumers, retailers and the authorities that duty had been paid.

11. Concerns have been expressed by the Scotch Whisky Association that the burden of compliance to be placed on the industry may outweigh the potential revenue benefit to the Exchequer from tax stamps. There will be costs for alcohol manufacturers in altering production lines to apply tax stamps and through the effect on cash flow of buying stamps well before the point of sale. Customs estimate that set up costs for the industry will be approximately £45 million and annual operating costs some £15 million.<sup>16</sup> Customs intend to help the trade in meeting these costs, which conflict with Customs' Public Service Agreement target to reduce the costs of compliance for legitimate traders.

12. Customs have also attempted to apply the "gap analysis" technique to predict the levels of beer and wine fraud. This methodology produces a negative gap, also due to under-reporting of consumption, implying that more tax is being collected than expected for the amount of beer consumed<sup>17</sup> Customs believe that "diversion" fraud is a relatively small problem for beer and wine and their estimates for these products therefore only include figures for cross-channel smuggling.

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15 Qq 120, 122, 135–143

16 Qq 13, 50

17 Q 61

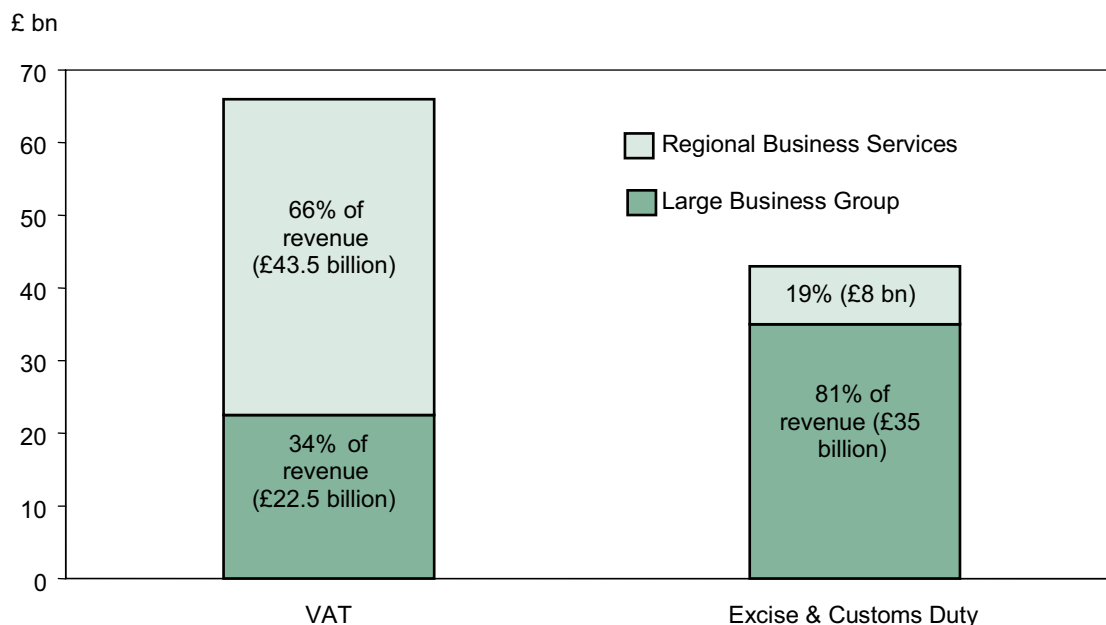
13. Poor communication between different parts of Customs engaged in the fight against alcohol fraudsters can have a negative impact on the ability of Customs to bring fraudsters to trial, as it can result in the loss of important evidence and documentation. The National Audit Office found this to be the case in five of the thirty six cases which they reviewed. Customs told us that they are implementing the recommendations made by Mr Justice Butterfield following his review, and although there had been some high-profile prosecution failures, overall Customs had a better prosecution record than the Crown Prosecution Service.<sup>18</sup>

## 2 Customs' management of revenue from large traders

14. The largest 1,050 businesses in the UK contribute 34% of VAT revenue (£22.5 billion) and over 80% (£34 billion) of Excise duty as shown in **Figure 3**. Our predecessors expressed concern in 1997–98 about the effectiveness of Customs' management of the tax affairs of these large businesses<sup>19</sup> Customs established the Large Business Group in April 2001, to recognise and manage the particular risks that this group of traders presents, with the remaining 1.7 million traders (including 1,200 large traders and many small and medium enterprises) managed by Regional Business Services.

**Figure 3: Breakdown of Customs' revenue by two major groupings**

The largest 1,050 traders contribute a significant proportion of Customs revenue



Source: HM Customs and Excise

15. Customs told us that there has been a move towards increased professionalism, better management control, improved relations with large traders and a significant focus on training of Customs staff.<sup>20</sup> Half of the 600 assurance officers in the Large Business Group have completed professional training. Customs are also developing sector specific expertise and risk analysis to strengthen oversight of individual traders and trade sectors.

16. Customs believe that these developments are beginning to improve revenue collection. The Large Business Group has achieved a 14% increase in yield in 2002–03 and targets for 2003–04 have been met three-quarters of the way through the year.<sup>21</sup> This will provide a significant contribution to Customs' overall target of closing the VAT gap. Although

19 29<sup>th</sup> Report from the Committee of Public Accounts, *HM Customs and Excise: Checking large traders' VAT liability* (HC 445, Session 1997–98)

20 C&AG's Report, para 2.3

21 Qq 5–6

figures published with the Pre-Budget Report<sup>22</sup> showed that VAT losses increased in 2002–03, the VAT Strategy introduced in April 2003 has already shown signs that it is yielding progress in tackling the VAT gap and missing trader fraud throughout the Department.

17. The challenge remains for Customs to measure the effectiveness of their new initiatives. Differences remain in performance measurement methodology and indicators used by the Large Business Group and Regional Business Services. The Department is moving away from just considering the identification and assessment of additional liability, which will not always represent hard collectable cash, to concentrate instead on actual revenue collected. This will connect better with measuring Customs progress in closing the VAT gap, which remains excessive.<sup>23</sup>

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22 HM Customs and Excise, *Measuring and tackling indirect tax losses*, December 2003

23 Qq 30–37

## Formal minutes

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**Monday 14 June 2004**

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allan  
Mr Richard Bacon  
Mr David Curry  
Mr Frank Field

Mr Gerry Steinberg  
Jon Trickett  
Mr Alan Williams

The Committee deliberated.

Draft Report (HM Customs and Excise Standard Report), proposed by the Chairman, brought up and read.

*Ordered*, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 17 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

*Resolved*, That the Report be the Thirty-second Report of the Committee to the House.

*Ordered*, That the Chairman do make the Report to the House.

*Ordered*, That the provisions of Standing Order No. 134 (Select Committees (Reports)) be applied to the Report.

Adjourned until Wednesday 16 June at 3.30 pm

## Witnesses

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**Monday 26 January 2004**

*Page*

**Mr Mike Eland, Mr Mike Hanson MBE and Mr Mike Wells**, HM Customs and Excise

Ev 1

## List of written evidence

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HM Customs and Excise

Ev 15

## List of Reports from the Committee of Public Accounts Session 2003–04

First Report	Tackling fraud against the Inland Revenue	HC 62 ( <i>Cm 6130</i> )
Second Report	The new electricity trading arrangements in England and Wales	HC 63 ( <i>Cm 6130</i> )
Third Report	The Sheep Annual Premium Scheme	HC 64 ( <i>Cm 6136</i> )
Fourth Report	Improving service delivery: the Forensic Science Service	HC 137 ( <i>Cm 6155</i> )
Fifth Report	Warm Front: helping to combat fuel poverty	HC 206 ( <i>Cm 6175</i> )
Sixth Report	Department of Trade and Industry: Regional Grants in England	HC 207 ( <i>Cm 6155</i> )
Seventh Report	Progress on 15 major capital projects funded by Arts Council England	HC 253 ( <i>Cm 6155</i> )
Eighth Report	The English national stadium project at Wembley	HC 254 ( <i>Cm 6155</i> )
Ninth Report	Review of grants made to the National Coalition of Anti-Deportation Campaigns	HC 305 ( <i>Cm 6175</i> )
Tenth Report	Purchasing and managing software licences	HC 306 ( <i>Cm 6175</i> )
Eleventh Report	Helping consumers benefit from competition in telecommunications	HC 405 ( <i>Cm 6191</i> )
Twelfth Report	Getting it right, putting it right: Improving decision-making and appeals in social security benefits	HC 406 ( <i>Cm 6191</i> )
Thirteenth Report	Excess Votes 2002–03	HC 407 ( <i>N/A</i> )
Fourteenth Report	Inland Revenue: Tax Credits	HC 89
Fifteenth Report	Procurement of vaccines by the Department of Health	HC 429
Sixteenth Report	Progress in improving the medical assessment of incapacity and disability benefits	HC 120 ( <i>Cm 6191</i> )
Seventeenth Report	Hip replacements: an update	HC 40
Eighteenth Report	PFI: The new headquarters for the Home Office	HC 501
Nineteenth Report	Making a difference: Performance of maintained secondary schools in England	HC 104
Twentieth Report	Improving service delivery: the Veterans Agency	HC 551
Twenty-first Report	Housing the homeless	HC 559
Twenty-second Report	Excess Votes (Northern Ireland) 2002–03	HC 560
Twenty-third Report	Government Communications Headquarters (GCHQ): New Accommodation Programme	HC 65
Twenty-fourth Report	Transforming the performance of HM Customs and Excise through electronic service delivery	HC 138
Twenty-fifth Report	Managing resources to deliver better public services	HC 181
Twenty-sixth Report	Difficult forms: how government departments interact with citizens	HC 255
Twenty-seventh Report	Identifying and tracking livestock in England	HC 326
Twenty-eighth Report	Driver and Vehicle Licensing Agency: Trust Statement Report 2002–03	HC 336
Twenty-ninth Report	Improving public services for older people	HC 626



Thirtieth Report	Out of sight—not out of mind: Ofwat and the public sewer network in England and Wales	HC 463
Thirty-first Report	Cambridge-MIT Institute	HC 502
Thirty-second Report	HM Customs and Excise Standard Report	HC 284

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number



# Oral evidence

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## Taken before the Committee of Public Accounts

on Monday 26 January 2004

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allen  
Mr Richard Bacon  
Mr Ian Davidson  
Mr Frank Field  
Mr Brian Jenkins

Jim Sheridan  
Mr Gerry Steinberg  
Jon Trickett  
Mr Alan Williams

**Sir John Bourn KCB**, Comptroller and Auditor General and **Mr Mike Suffield**, Director of Customs and Excise Financial Audit, National Audit Office, further examined.

**Mr Brian Glicksman**, Treasury Officer of Accounts, HM Treasury, further examined.

### REPORT BY THE COMPTROLLER AND AUDITOR GENERAL:

#### Standard Report 2002-03

#### HM Customs and Excise:

*Witnesses:* **Mr Mike Eland**, Acting Chairman, **Mr Mike Hanson MBE**, Director General, Business Services and Taxes and **Mr Mike Wells**, Director of Law Enforcement Policy, HM Customs and Excise, examined.

**Q1 Chairman:** Good afternoon and welcome to the Committee of Public Accounts where this afternoon we are looking at the Comptroller and Auditor General's 2002-03 Standard Report on HM Customs & Excise. There are two key parts of the Report which I shall certainly want to look at: the risks to revenue in the large business environment; and managing the risks of alcohol fraud. We welcome Mr Mike Eland, who is Acting Chairman of HM Customs and Excise. Good afternoon. Could you introduce your team?

**Mr Eland:** Good afternoon, Chairman. May I introduce my colleagues, Mr Mike Hanson, who is Director General, Business Services and Taxes in the department? Until a few weeks ago he was also the Principal Finance Officer and today he is here in that capacity. On my left is Mr Mike Wells, who is the Director of our Law Enforcement Policy.

**Q2 Chairman:** Thank you very much for agreeing to appear before us this afternoon. You gave statistics to the Pre-Budget Report which show that your VAT losses are increasing. Correct?

**Mr Eland:** Yes, that is right.

**Q3 Chairman:** What does this say about your work with large businesses if your VAT losses are increasing?

**Mr Eland:** The losses had gone up in the year before we launched our VAT strategy in April 2003 and the indicators in 2003 have shown that we are making some very solid progress in tackling that and getting the gap down. VAT receipts are currently running £2 billion ahead of forecast and we also have considerable evidence that we are beginning to

tackle missing trader frauds successfully. We think we are well on track to getting fraud levels down again in the VAT area.

**Q4 Chairman:** Could you please look at paragraph 2.14 on page 12 of the Standard Report? Can you explain to the Committee how you know if you are targeting your resources to the sectors which present you with the highest risk?

**Mr Eland:** We have conducted an examination of the various sectors in which we have looked at a number of factors, like the complexity of that area, amounts of tax at risk and carried out a sector by sector appraisal using that type of criteria. Underpinning that is our central risk assessment, where we are also giving an assessment of each individual business. We believe that between the two of those activities we can get a fairly well informed picture of risk, although obviously this is something we are continually seeking to improve.

**Q5 Chairman:** Can we now look at the approach you have adopted with your Large Business Group? It is dealt with on page 13, paragraph 2.16. You have a more intensive approach which you adopt with the Large Business Group, the largest companies, you have a much more personal approach, do you not?

**Mr Eland:** Yes.

**Q6 Chairman:** Is it yielding results and how can you tell?

**Mr Eland:** Yes, we think it is yielding results. We have various measures we use to measure success. One of the most important of those is the future revenue benefit, because clearly under the VAT strategy what we are looking to do is to improve yield. In the year 2002-03, we saw an improvement

## HM Customs &amp; Excise

of 14% from the Large Business Group in that measure and in this current year, three quarters of the way through the year, they have already hit the targets which they were due to hit. We can see a very good performance coming through.

**Q7 Chairman:** May I now turn to three or four questions about alcohol fraud? Can we start by looking at pages 31 to 32, paragraphs 3.20 to 3.21? We see there “Customs face difficulties in obtaining accurate figures for total UK consumption”. Without adequate estimates of fraud, how do you know whether you are tapping resources in the right way?

**Mr Eland:** We have to remember where we come from here. Until three years ago we had no estimates for fraud at all. Since then we have done a lot of work to develop overall measures of the size of illegal markets and the amount of fraud.

**Q8 Chairman:** You do not know the scale of the problem.

**Mr Eland:** Yes, we do.

**Q9 Chairman:** Tell us a bit about that then.

**Mr Eland:** We believe that at the moment spirits fraud is on the increase, that it has risen from £450 million to £600 million and we have developed a package of measures which we announced in the PBR to tackle that.

**Q10 Chairman:** May I ask about intelligence, which is dealt with on pages 36 to 37, paragraphs 3.34 to 3.35? Can you tell us about the contribution intelligence makes to your work?

**Mr Eland:** Intelligence obviously makes a very important contribution in terms of helping investigators in their activity; intelligence contributes information from informants and the like. Intelligence also informs, through more general profiling, the way in which our detectors at ports and airports tackle fraud and also inland activity as well. It is an important part of our process.

**Q11 Chairman:** Can we now look at co-operation between departments and page 32, paragraph 3.24 where it says “On the other hand, in three of the 36 cases which we reviewed, ineffective communications between different areas of Customs hindered the successful investigation and prosecution of fraudsters. How much is this a problem in your organisation, that the left hand does not know what the right hand is doing?”

**Mr Eland:** We do not think it is a serious problem, but in any large organisation, you are going to have communication difficulties; that is typical of any large organisation. It is something managers constantly have to work at. In this particular area, our strategic approach has improved communications, because everybody is given a specific task they are engaged with and that enables them to see how they fit in with the broader picture. We have overcome some of those difficulties of people pursuing their own particular objectives without taking account of other people’s. You will

get examples where that breaks down and when we do find that we will tackle it. We debrief after any operation like that where there have been those problems and we are working on measures like the Fulcrum Initiative which is shown in this Report as an example of setting up cross-departmental teams which can effectively tackle a problem and demonstrate the value which comes through cross-departmental working.

**Q12 Chairman:** Can I give you an opportunity to say something about tax stamps? This is dealt with in paragraph 3.16. You will see there what we know very well “The industry lobbied against this plan due to the likely cost of compliance”. You have a public service agreement target to reduce the cost of compliance in the industry?

**Mr Eland:** Yes.

**Q13 Chairman:** How do you square that with the proposal to bring in tax stamps?

**Mr Eland:** We want to reduce compliance costs where we can, commensurate with our other Public Service Agreement target of reducing fraud. In this case it is true that there will be compliance costs for the industry from tax stamps. We estimate those as being about £45 million in setup costs and £15 million thereafter. They will, however, produce a revenue benefit of £164 million and we think that is a proportionate cost/benefit ratio.<sup>1</sup> Ministers have, however, made it clear that they are both willing to consider looking at measures which will mitigate the costs of compliance in this area and they are also willing to contemplate alternatives to tax stamps if an effective alternative measure can be identified.

**Q14 Chairman:** You are obviously aiming to reduce the level of spirits fraud. What would you view as a success and when do you hope to achieve this?

**Mr Eland:** We do not have a public service agreement target set yet; the intention of the government would be to set one as part of the SRO4 process and that will depend on the overall view of resources, the regime changes we are proposing and the target they wanted to set us as a result. Clearly we want to stop the rising trend and get it coming down again.

**Q15 Mr Allan:** May I continue on this area of alcohol fraud? You said that the Customs’ estimates for spirits fraud have increased from £450 million to £600 million. Could you just confirm the period?

**Mr Eland:** It has gone up from 2001–02 when it was £350 million to £450 million and the last projection for 2003–04 is £600 million.<sup>2</sup>

**Q16 Mr Allan:** Are those all on the same methodology?

<sup>1</sup> *Note by witness:* The current estimate of the revenue benefit of Tax Stamps is £160m.

<sup>2</sup> *Note by witness:* Customs’ estimate for spirits fraud was £350m in 1999–2000 and £450 million in 2000–01. The last projection for 2001–02 is £600m.

## HM Customs &amp; Excise

**Mr Eland:** They are on the same methodology. We update them in each PBR. It is a series which has been set out in each PBR for the last three years and when we publish them we set out the methodology by which we have done that.

**Q17 Mr Allan:** That is presumably not a view of the total size of the alcohol market growing to such a degree as that. Can we assume that a greater proportion of the same alcohol consumption is now illegal as opposed to legal?

**Mr Eland:** Yes. We take into account consumption and basically it is a gap analysis between what we should be collecting if everybody were paying tax on the consumption figures and what we are actually receiving.

**Q18 Mr Allan:** You have not assumed massively growing consumption.

**Mr Eland:** As consumption goes up, the fraud figure goes up as well.

**Q19 Mr Allan:** Not in the kind of proportions we have just heard about from £350 million to £600 million over a couple of years. That would be a dramatic increase in consumption.

**Mr Eland:** Indeed.

**Q20 Mr Allan:** Within those figures, how much do you think is the large-scale organised fraud described here as diversion offences, where people, businesses effectively, divert alcohol on which duty has not been paid and get it somehow into the market, as opposed to the *ad hoc* fraud, the man with the Transit van. How much will you put into those camps?

**Mr Eland:** We think it is overwhelmingly diversion fraud. There is some smuggling across borders but overwhelmingly it is diversion fraud and on a fairly large scale.

**Q21 Mr Allan:** By value these are large-scale organised criminal rings.

**Mr Eland:** Yes.

**Q22 Mr Allan:** Can you square the figures you have just given me with the fact that my understanding from your own figures is that the seizures of spirits fell from three million litres in 2000–01 to 2.1 million litres in 2001–02? It seems curious that you are estimating a growing problem, yet your success is—

**Mr Eland:** This is because of the nature of the fraud shifting. There are different types of diversion fraud. There is inward diversion fraud where goods are brought across the frontier posing as legitimate consignments and there is outward diversion fraud where things are going supposedly for export, but never make it. The balance has shifted over to outward diversion fraud now, largely because of the impact we have had on inward diversion fraud. Seizures occur much less frequently with outward diversion fraud by the nature of it. Clearly with inward diversion fraud, it is crossing a Customs control point and therefore we are more likely to

make a seizure. With outward diversion fraud we are usually finding out after the load has moved and taking action from that end of it.

**Q23 Mr Allan:** May I ask about the prosecutions? My understanding is that the figures for 2002–03 were: only 24 prosecutions for evading duty on spirits, 21 successful and three unsuccessful; 62 prosecutions for cases involving the evasion of duty on mixed excise goods, which may have included spirits. That seems a dramatically low figure, given the scale of the offending which seems to be taking place.

**Mr Eland:** Prosecutions are not the only measure of success; particularly with diversion fraud, it is often very difficult to get together the evidence to a criminal standard of proof. That does not mean that we are not successfully disrupting the activity by seizures of lorries and seizures of goods and imposing sometimes compound financial penalties. We do look to prosecute very much as part of our strategy.

**Q24 Mr Allan:** May I ask about the issues from the failed prosecution on the London City bond warehouses, which is referred to in paragraph 3.3? I understand that they failed in January 2003 and there was a report in July 2003. Are those issues which came out of that failure now resolved?

**Mr Eland:** Yes. The Butterfield inquiry has completed its examination and made recommendations which we are now implementing in relation to that.

**Q25 Mr Allan:** May I just pick up on this point about the stamp solution? Have we taken evidence from other EU countries where stamps are in common usage? Do you have reason to believe or authoritative evidence you can put forward to show that where people are using stamps it does significantly tackle this? It does seem that if we introduce a new measure and yet still fail to get hold of it, then business will have a serious complaint to level against us.

**Mr Eland:** Yes. We have been in contact with Denmark and Spain, both of whom believe that tax stamps are helpful in tackling fraud and obviously we will continue the dialogue as we continue with this examination.

**Q26 Mr Allan:** In the EU context, the *ad hoc* casual fraud is clearly taking advantage of differential duty regimes in different EU countries.

**Mr Eland:** Yes.

**Q27 Mr Allan:** With the diversion fraud, because they are not paying excise duty anywhere, it does not really make any difference whether the French put up their tobacco price, as they have done recently; that is not going to be affected by any kind of levelling up or equalising of EU duty rates, is that correct?

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*Mr Eland:* Yes, that is correct.

**Q28 Mr Allan:** Does the EU expansion to the east pose additional problems for you, in that, as I understand it, part of the difficulty is that these are chains of warehouses which the material passes through? Should we expect having a larger range of countries and locations into which material may go to make life more complex for you?

*Mr Eland:* Potentially it can, but clearly even within a European Union of 15 countries there is plenty of capacity for creating very complex chains. Expansion certainly could change the picture in some areas. For example, it could potentially increase the risk of white spirits smuggling, vodka and so on.

**Q29 Mr Allan:** Do you have any evidence to suggest that this kind of fraud is linked up with other forms of organised crime? Does it fall within a family of criminal activities or is it discrete as far as you are aware?

*Mr Eland:* It is difficult to pin that down totally. We have seen some evidence of tobacco smugglers moving into spirits smuggling, but it is only some evidence. I would not want to put too much weight on it.

**Q30 Mr Jenkins:** As lay persons going through the Report we get confused on occasions and have to ask for some clarification of the terms you use. When I was looking through this I noticed on page 14, paragraph 2.19 that you have this system where you use revenue yield as an indicator to assess your performance rather than net additional liability, which includes large amounts of irrecoverable debt such as that relating to missing trader fraud. Am I right in saying that you just moved your assessment criteria, saying that you would not bother with missing trader fraud as you could not deal with that and you would use this other objective, or would I be totally wrong in reading it that way?

*Mr Eland:* No, that is not the case. We are certainly looking to tackle missing trader fraud and it is one of our top priorities at the moment. The reference here is that if we just use net additional liability as our measure of general success in the VAT assurance field, it does not reflect the amounts of money actually going into the exchequer, because some of it is irrecoverable for the reasons given. What we are looking to do is to try to move away from that measure, to supplement it with other measures which more adequately measure what we are achieving. We are looking to improve the measures here.

**Q31 Mr Jenkins:** You are measuring what you can achieve rather than what you should achieve.

*Mr Eland:* No, we are trying to measure what we should achieve, which is the amount of money going into the exchequer. Obviously if we are measuring net additional liability and some of it does not go into the exchequer, then we are actually giving ourselves an easier measure.

**Q32 Mr Jenkins:** Over the page in paragraph 2.22 it says “Despite measuring Net Additional Liability, Large Business Group do not believe it is an appropriate measure of success and do not have targets for it”. Why?

*Mr Eland:* Because we are trying to move away to a more successful set of measures which measure what we are being asked to achieve in terms of the VAT strategy, which is to improve revenue yield, and net additional liability does not wholly measure that.

**Q33 Mr Jenkins:** In Figure 2.5 on net additional liability I notice that in 2001–02 you have made some rather large gains and achievement against target percentage on the LBG line is 102% and on TG6 20%. Is that because you set your targets too low?

*Mr Eland:* No, because these are not targets, they are just measures and they are just showing what we have achieved in each of those years. The targets are really related to yield and closing the VAT gap, where we want to get it from 15% not recovered down to 12%. These are measures showing how, on both future revenue benefit and net additional liability, we are doing against that. I am sorry; I am clearly not making myself clear. It is quite complex.

**Q34 Mr Jenkins:** It says in Figure 2.5 achievement against target percentage, so I just thought it was a mark-up against target. I am not reading this wrongly, am I? Achievement against target percentage at the top, LGB is 102% and TG6 is 20%, is it not?

*Mr Eland:* Yes, it is. As the footnote indicates we want to shift our focus away from these measures, despite the fact that it looks as though we are doing extremely well against these targets. They are not a satisfactory measure of what we are trying to achieve in terms of improving overall yield. We think the future revenue benefit is a much better measure, because it is concentrating the minds of our visiting staff not just on the immediate tax which they might find for that year, but on getting it right for the future. We are trying to move it away from these sorts of measures towards those other measures.

**Q35 Mr Jenkins:** You are not going to measure existing targets because they are not really a good measure.

*Mr Eland:* They are not satisfactory.

**Q36 Mr Jenkins:** You are moving to some new targets.

*Mr Eland:* To try to direct the efforts of our staff more towards what we are being asked to do by government, which is to close the gap by increasing that yield.

**Q37 Mr Jenkins:** I am trying to understand.

*Mr Eland:* I am sorry if I have not explained it; it is very complex.

**Q38 Mr Jenkins:** It is very difficult if you are not working in the area, I understand that. I notice on the question of tax stamps on alcohol that you said

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you would hopefully get in an additional £164 million.<sup>3</sup> That was an estimate of what the tax stamp could make for us.

**Mr Eland:** Yes.

**Q39 Mr Jenkins:** So at a cost to the industry of maybe £15 or £16 million you get in a tenfold increase. It sounds a good deal to me, but it is far short of the £650 million which you have estimated as the non-collected tax in this area.

**Mr Eland:** Yes.

**Q40 Mr Jenkins:** You got this estimate by using something called gap analysis.

**Mr Eland:** Yes. We estimate what the total amount of tax should be and then compare that to the amount of tax which has actually been collected.

**Q41 Mr Jenkins:** This gap analysis is when you go around the country asking people what they consume?

**Mr Eland:** No. It is done on the basis of figures collected by, in this case, Defra and the Office for National Statistics. These are consumption statistics which are collected centrally by government for a whole variety of purposes which we use for this purpose too.

**Q42 Mr Jenkins:** How do they collect these statistics? How do you actually measure what consumption is?

**Mr Eland:** I believe it is partly by survey and then they adjust that statistically. Certainly one of the issues in the alcohol area is whether people do understate their alcohol consumption in surveys and a statistical adjustment is made to take account of that.

**Q43 Mr Jenkins:** It is interesting because the figure jumped so dramatically and there is no reason why it should jump so dramatically.

**Mr Eland:** It has gone up by £150 million and clearly that is a worrying trend. In relation to the total amount of alcohol duty, that is equivalent to about a 16% illegal market.

**Q44 Mr Jenkins:** I remember in a previous hearing, when we were talking about tobacco and tobacco smuggling, that one of the methods they used was to go to a football stadium and pick up all the cigarette packets at the end of the match and see which ones were home produced and taxed and then the percentage which were not taxed. I can picture you going around the stadiums looking for empty bottles and deciding which ones had come in and which ones were genuinely British produced. Could you follow a similar scenario with the producers of the product? Are any producers of particular concern in this area?

**Mr Eland:** No, we do not have the same problems as we have explored in this Committee in the tobacco area. The main problem we have in the alcohol area is that, unlike either oils or tobacco, there is no

marking which enables you to say this is duty paid. That is why we think tax stamps are an important part of tackling this problem. Most of the diverted spirit which is sold is sold through legitimate retail chains and the like. It is not like tobacco where you have these illegal markets. We think about 80% of spirits are sold through legitimate chains, quite innocently on the part of the retailers who have no means of distinguishing whether it is a tax-paid or not a tax-paid product. The tax stamps will enable us to do that.

**Q45 Mr Jenkins:** If it is a commonly accepted problem why do the spirit manufacturers disagree with your figures?

**Mr Eland:** They are concerned about the compliance costs. We are sitting down talking with them, explaining our methodology; they have some alternative estimates and we are looking at those and comparing notes. We are gradually working through a series of meetings doing that. They have asked us for more information and we are in the process of providing it.

**Q46 Mr Jenkins:** Do have a figure from the manufacturers to say how much they think the total will be, not £650 million obviously but something like £150 million?

**Mr Eland:** They are more in the £100 to £150 million range.

**Q47 Mr Jenkins:** Exactly, so why are your methodologies showing such a marked variance here?

**Mr Eland:** This is precisely what we are exploring with them now, why they think their method is superior to ours and we are explaining why we stand by ours. We have had this series running now for three years and we have set out how we have calculated it in each of those years. It has been a perfectly transparent exercise; it is not a new thing which has just come out of the blue.

**Q48 Jim Sheridan:** Would it be fair to say that organisations such as the Scotch Whisky Association are not too happy with these proposals? I take it that you have met with them and talked through some of the concerns you have already identified.

**Mr Eland:** Indeed.

**Q49 Jim Sheridan:** There seems to be some ambiguity about what your figures are suggesting and what organisations such as the Scotch Whisky Association are suggesting and the methodology seems to be unclear as well. Is that a fair assessment?

**Mr Eland:** I do not think the methodology is unclear. There is debate about which are the best consumption data to use and that sort of thing. We are having very constructive discussions; we have had a number of meetings looking both at the estimates of fraud and why we think that it takes the form it does and also compliance costs. Those discussions are continuing.

<sup>3</sup> *Note by witness:* The current estimate of the revenue benefit of Tax Stamps is £160m.

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**Q50 Jim Sheridan:** Has there been any detailed assessment of the impact, particularly on legitimate producers in the industry? Has there been any estimate of the cost to industry and particularly the impact it could possibly have on jobs?

**Mr Eland:** We have an estimate of compliance costs. I mentioned £45 million initial costs and £15 million a year thereafter. That figure was derived from talks we had with the trade when we last looked at this two years ago. We are now continuing talks to see where that needs to be updated. I would also emphasise that, as the Chancellor announced in the PBR, he is willing to contemplate, if tax stamps were to go ahead, looking to mitigate the costs to industry either by a freeze on spirits duty or by changing the deferment period so that they have a cash flow advantage extended or something like that. It is not just a matter of establishing the compliance costs, it is also looking at what can be done to mitigate those as well.

**Q51 Jim Sheridan:** Am I correct in saying that an assessment has been carried out on the loss of revenue as a result of these compliance costs? Obviously the price of the product may have to go up to meet the costs.

**Mr Eland:** Clearly £15 million spread across the entire spirits industry should not have a huge impact on price, but if that were then partially offset by some other measure, that would be even less. It does depend on looking at both sides.

**Q52 Jim Sheridan:** Effectively it eradicates the freeze on tax on Scotch whisky announced in the Chancellor's budget; that could effectively be rubbed out by the increase which may have to be put on because of these compliance costs.

**Mr Eland:** The talks we are having with the industry will hopefully identify various options and this coming budget in the spring of this year will be a time at which those decisions can be taken.

**Q53 Jim Sheridan:** I hope these figures are correct, but given that it is estimated that you will recoup something like £160 million of the claimed £600 million, which is somewhat unclear, do you really think that is enough to stop the twisters?

**Mr Eland:** That is the amount which would be attributable purely to the tax stamp change. We will be looking in the spending review this year at what targets should be set for going beyond that over the period and what that will involve for us as well. That is not the only measure we are going to take to tackle the £600 million, but it is a central part of it.

**Q54 Jim Sheridan:** Mr Wells, could I digress ever so slightly. Given that you are Director of Law Enforcement Policy, if we can identify loss of revenue to the Treasury and other disciplines, which is difficult at this stage to trace, and hold accountable those who are doing it, do you think the introduction of effective legislation would help in terms of tracking down people who are evading taxes?

**Mr Wells:** We have applied the same methodology across each of our taxes now; we have applied this methodology to oils, to the VAT missing trader problem and also tobacco. In all of those areas we have taken legislative measures to enable better identification and better tracking of illicit product. Certainly that is an important issue in the alcohol area and tax stamps are one means of helping everybody, from Customs to the trade to retailers to consumers, to identify the licit product from the illicit product and to trace the movements of one as compared to the other. At the present time it is exceedingly difficult to distinguish tax paid from non-tax-paid spirit in contrast to oils and tobacco where there are markings on the licit products to identify one from the other.

**Q55 Jim Sheridan:** I am sorry to labour this point, but where there is clear evidence of evasion of tax and of the voluntary code not working, the Treasury then do not have any problem with looking at effective legislation, for instance to license traders who are evading tax.

**Mr Wells:** Those who are engaged in selling alcohol are already licensed and certainly Customs already have the opportunity to, and we certainly do, raise objections to the renewal of liquor licences in those instances where we can establish that illicit trading has taken place. At the moment one of the difficulties is establishing, as we put it, guilty knowledge in those circumstances; it is extremely difficult to demonstrate that a retailer of illicit alcohol was necessarily aware that it was indeed illicit because there is no obvious distinction which is visible between the tax-paid and non-tax-paid product.

**Q56 Mr Steinberg:** This is a very low key hearing and perhaps we should liven it up a little. I do not know what you think.

**Mr Eland:** I am perfectly happy.

**Q57 Mr Steinberg:** It is quite clear that the amount by which the Treasury is being defrauded is between £600 and £700 million. One could argue that is not a lot of money, bearing in mind the amount of tax you have taken in which for alcohol is £7 billion. I was just going to work out the percentage when the Chairman called me, but there are so many noughts there I do not think I can do it. It must be a very small percentage. How much is taken in duty on tobacco?

**Mr Wells:** We collect around £8 billion.

**Q58 Mr Steinberg:** So that is £15 billion in duty on alcohol and tobacco. How much is not paid in tobacco duty? Approximately how much fraud is there?

**Mr Wells:** Round about 18% of the cigarette market is illicit, so, doing my sums very rapidly, that is somewhere in the order of £2 billion I would say.



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**Q59 Mr Steinberg:** So we are talking about close on £3 billion. So we are being a bit complacent, are we not really? Three billion pounds out of a lot of money is still a lot of money. It seems to me that the problem is recognised but not a lot is done about it.

**Mr Eland:** On the tobacco front we have got the illegal market down from over 21% and rising, to 18%, so we are making progress in that area. We have introduced a number of measures in the alcohol area which I should like to think have stopped it rising as rapidly as it might have, but clearly we have not done sufficient, which is why we are now looking to introduce tax stamps and various other measures which were announced in the PBR as an attempt to get that down as well.

**Q60 Mr Steinberg:** From the Report it appears that you do not know accurately how much fraud there actually is. If you do not know how much fraud there is, how can you take effective measures to stop what you do not know is happening?

**Mr Eland:** There are estimates. We believe they are good quality estimates. We have been working on them for three years, they have been examined by different people in that time including the NAO. We do not know for certain, but we have good quality estimates. Three or four years ago we did not even have those. We have made a lot of progress in setting up these estimates, precisely, as you say, so that we know what the problem is and we can tackle it.

**Q61 Mr Steinberg:** How come it is much easier to estimate the fraud in tobacco and you seem to be able to judge how much fraud there is in spirits, yet you cannot do this for beer and wine? The Report seems to suggest that you have no idea on beer and wine. Why is that?

**Mr Eland:** We have not been able to do this gap analysis, but we do know that in the beer area one of the major problems was the white van trade, the cross-Channel smuggling and we have a separate set of indicators there which has enabled us to confirm that we have pretty well got on top of that. Mr Wells might want to add something on the wider beer and wine market.

**Mr Wells:** The problem with a gap analysis on beer and wine is that it tells us that we have a negative gap, in other words that we are collecting more tax than there is beer being consumed, which is unlikely. We draw two principal conclusions from that: one that people understate their consumption of beer, which I think we probably knew already—I guess we probably all do that from time to time; secondly, we believe that the problem on beer is relatively small and therefore we are talking about a gap which is right at the margins of measurement. We believe that the overwhelming supply of illicit beer in the past has been through the so-called white van, cross-Channel passenger smuggling and we have reduced that very substantially through our activities on the cross-Channel routes.

**Q62 Mr Steinberg:** In paragraph 3.3 we are told “. . . in January 2003, a number of prosecutions relating to major alcohol fraud perpetrated through London City bond warehouses collapsed”. Why did they collapse?

**Mr Eland:** It collapsed because of defects in our investigation. We had not been able to identify fully documents which needed to be disclosed; procedural failures in the prosecution.

**Q63 Mr Steinberg:** That brings me on to the fact that we have had a gentleman writing to us over the last few months about the fact that Customs and Excise have failed miserably in a number of cases. This gentleman is arguing that potential criminals are walking away basically because of the incompetence of the investigating staff and the way cases are presented; criminals are walking away yet the ordinary citizen who messes up his VAT is being penalised quite considerably. How do you answer that? Frankly we do hear very often on the television about a case collapsing because of this, because of that, because Customs did not present the case properly. You have just told us that the London City one collapsed for that very reason. Is that not a serious concern?

**Mr Eland:** It is a serious concern to us certainly and there was a period in the mid-1990s which is where a lot of these investigations originated, where our procedures were not up to it. We have made a whole lot of changes since then. We had a judicial inquiry looking into those City cases and Mr Justice Butterfield who conducted it thought we had made huge progress since then. I am hoping that for the future we are going to—

**Q64 Mr Steinberg:** If you do look at the Report, paragraphs 3.38 and 3.39—presumably we have all read it so I shall not read it—they do make pretty poor reading in that there seems to be no liaison with other departments and departments are not working with each other and therefore information is not divulged by one department to another department. If that is the case it is no wonder things go wrong.

**Mr Eland:** I do not think there is any evidence there of any systemic failure. Certainly there are isolated cases where people have not properly brought in others when they should but it is a very small number of cases out of the total which the NAO examined; it is three out of 50.<sup>4</sup>

**Q65 Mr Steinberg:** Could you tell me, as a matter of interest, whether you use former police officers as your investigating officers?

**Mr Eland:** Yes, we do have some people who are former police officers. We do recruit outside in the recruitment market for some of our investigators; others come from within the service.

<sup>4</sup> Note by witness: Part 3, paragraph 3.24 of the NAO Standard Report 2002–03 “*Managing the Risks of Alcohol Fraud*” quotes the figure of 3 out of 36 cases.

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**Q66 Mr Steinberg:** It seems to me that in specialised activities such as prosecuting and evidence and presenting evidence you want somebody who is properly trained.

**Mr Eland:** I would not want you to think, because there have been some high profile prosecutions which have gone wrong that our overall record is unsatisfactory. In fact our overall success rate in prosecutions is better than the Crown Prosecution Service.

**Q67 Mr Steinberg:** Could you send us a note on the statistics of how many prosecutions you have had in, say, the last five years and how many have been successful and how many have not been successful and why they have not been successful?

**Mr Eland:** Yes, we certainly can do that.<sup>5</sup>

**Q68 Mr Steinberg:** We have talked about the tax stamp. Even before I read this Report I thought to myself that there was one way you could guarantee that you get your tax and that is to tax the product at its manufacturing stage. Why do you not do that? Why do you not, for example, at Newcastle Breweries tax them on every barrel of beer that they produce and then you could have a rebate system so that once it is sold, wherever it is going, the tax could be refunded. I accept that would be expensive, but presumably the amount of money which would be saved would cover the administration costs.

**Mr Eland:** It would be very expensive for us and it would cost the industry quite a lot. It would be possible to circumvent it by exporting and then bringing things back in from overseas. I am afraid that is not the total answer.

**Q69 Mr Davidson:** Could I ask about the comparison between the trade here and the trade in cigarettes? As you know, this Committee have been very supportive of your work with cigarettes. The fraud there could be characterised as being large-scale, blatant collaboration or conspiracy between the companies and the smugglers and the companies in some cases being obstructive and unhelpful. Is that the case with any of the spirit companies?

**Mr Eland:** No, we have had some very good help from them over the last year in terms of talks about how they can provide information and so on to us. It is not the same. Obviously within the total industry there might be some instances.

**Q70 Mr Davidson:** If you are saying yes, generally the spirits industry is entirely different to the tobacco industry, that is helpful. In terms of the pattern of seizures, do the seizures show you anything if you follow them back? Is there any particular company product which is disproportionately represented amongst seizures? Any particular channel of distribution which is disproportionately represented amongst seizures?

**Mr Eland:** No, I do not think there is anything as distinct as that. It is a much more diverse industry than tobacco. Certainly it is white spirit fraud as well as Scotch whisky fraud; it is not a Scotch whisky problem.

**Q71 Mr Davidson:** There is an issue here about the methodology you are using and evidence of the difficulties. In Glasgow, certainly in the Barras market, illicit cigarettes are sold openly. There is no evidence of that for spirits. We have people selling cigarettes round the doors, we have shopkeepers with cigarettes under the counter. There is no evidence of any of that for alcohol. Can you clarify for me what evidence there is that there is such a scale of difficulty?

**Mr Eland:** The distinct thing with the distribution of illegal spirits and alcohol is that it gets into the legitimate chain and people charge the retailers there virtually the full wholesale price. It is a totally different market dynamic really.

**Q72 Mr Davidson:** So it is not the final user who is making the money, say the publican or the shopkeeper, it is the people who are supplying them.

**Mr Eland:** It is back in the chain. It is a large-scale criminal gang problem.

**Q73 Mr Davidson:** Certainly looking at the estimate you gave us of the scale of the illegal trade, something like 200,000 bottles a day in the UK, which is over 2,000 per constituency per week, I see no evidence of there being that amount of Scotch or any other spirit being marketed illegally in my constituency. That is covered to some extent by your point that it is all through the legitimate trade. May I ask about choke points? You have already touched upon choke points in ports in terms of imports. What risk analysis work has been done to identify the 20 or 30 warehouses which are most likely to be involved in this trade? I am making the assumption that you would not regard the producers as being a source of high risk or if you would, it would be helpful if you would tell us.

**Mr Eland:** We have gone through every warehouse in terms of revisiting it, looking at the people involved in that and so on. We are carrying out a full risk analysis of the trustworthiness of the different—

**Q74 Mr Davidson:** Are you doing that now?

**Mr Eland:** We have now completed that.

**Q75 Mr Davidson:** As I understand it there are people running warehouses who would not be considered fit and proper persons to run public houses under the tests which are applied for public houses, but there is no equivalent test for warehouses.

**Mr Eland:** We would look into the background of the warehouse keeper and if there were evidence of criminal convictions or something like that, then we would take that into account in whether or not we gave approval. If there were a fraud problem in the past, we would not.

<sup>5</sup> Ev15

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**Q76 Mr Davidson:** Do you have the power then to debar somebody from being a warehouse keeper?

**Mr Eland:** We have the power, yes, and we do refuse.

**Q77 Mr Davidson:** Since every warehouse operator has not been disqualified by you, you must presumably be satisfied with all the warehouse keepers there are at the moment.

**Mr Eland:** Having gone through this process that we have been through, then yes. Obviously it is a changing population and we have to keep it up to date.

**Q78 Mr Davidson:** Could I turn to the question of the model which you are using which I find difficult to understand entirely, I must confess? Am I right in assuming that the growth of illegal sales assumes that the spirits market has risen by just under 40% over the last decade?

**Mr Eland:** Yes.

**Mr Wells:** Yes.

**Q79 Mr Davidson:** What other evidence is there that the rise in the spirits market has been 40% over the past decade apart from your analysis?

**Mr Wells:** To be clear, that is not our analysis, it is the data which we take in turn from the Office for National Statistics and from Defra.

**Q80 Mr Davidson:** That is a gap analysis, is it not?

**Mr Wells:** No, they provide us with the basic data on overall consumption and growth over that period of time. The growth in total consumption is provided from the data they give us.

**Q81 Mr Davidson:** This is obviously disputed by the industry, as you will probably be aware. They say there is no evidence that consumption has gone up by 37% and their estimate of the British market is that it was level for a while and then rose when the Chancellor froze duty. What steps have you taken to reconcile these two really quite widely varying estimates?

**Mr Eland:** We are having talks between the two groups of experts in an attempt to do precisely that.

**Q82 Mr Davidson:** Could I ask the National Audit Office how happy they are with the methodology presently being used by the department and how robust they believe it is?

**Mr Suffield:** When we looked into this we recognised that there were problems with the methodology and recognised that certain elements of the spirits producers did take issue with it. This is not an exact science; it is probably something which would warrant further discussion. I note what Mr Eland says in terms of the ongoing discussions with the trade and it is important to see how they can be reconciled so that these two really quite different perceptions can be brought together.

**Q83 Mr Davidson:** Before the government moves to a final decision on tax stamps, will the National Audit Office be assessing the extent to which there has been a reconciliation on making an assessment of where the disagreements lie?

**Sir John Bourn:** We certainly shall be looking at that to see the importance of understanding why these methodologies produce such different results and which the best one is to put your money on.

**Q84 Mr Davidson:** May I ask about the distribution of the illicit stock? As I understand it, your argument is that 80% goes through legitimate channels.

**Mr Eland:** Yes.

**Q85 Mr Davidson:** The trade would say that 75% of whisky sold legally goes through supermarkets and there is presumably then another 5% or 10% going through chains of off-licences, which together account for about 80% to 85%. I am not clear whether or not you are saying those large reputable companies are involved in buying illicit Scotch and other spirits?

**Mr Eland:** In our estimate it is more the middle range downwards rather than the very large supermarket chains.

**Q86 Mr Davidson:** That would mean effectively that the remaining share of the market, we are talking there about 15% to 20% of the market, is taking virtually all, 80% plus, of the illicit trade, which means almost one bottle in two sold through corner shops and the like has evaded duty. That does seem unduly large as a percentage, does it not?

**Mr Wells:** To give you an example which goes to illustrate what you are saying, one of our London assurance teams has been targeting exactly the smaller and middle range retailers and in some of their work they have been having hit rates of 60% or so in terms of the detections they have made of illicit product in those smaller outlets. It is of the order you are suggesting.

**Q87 Mr Davidson:** If you have identified, say, a particular shop where 60% of its stock has evaded duty, presumably you must then be able to follow that back? There must presumably be paperwork which then allows prosecutions. If you are saying it is sold into the legal trade ... Could you just clarify for me? Are you saying that the shopkeeper has no paperwork and he has bought it off the back of a lorry but is selling it at the full price? Or are you saying he has bought it through some false wholesaler who has provided him with paperwork, in which case presumably you could follow that back and you have somebody to charge at that point?

**Mr Wells:** It is always a complex mixture of the two. Sometimes paperwork exists, sometimes it does not, sometimes fraudulent paperwork exists and yes, you can follow it back. The chains for fraudulent supply are often very complex and go through a series of links and often the fraudster is an entity outside the UK or turns out not to exist, is fictitious in some way. It is often very difficult to follow those chains

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back. Certainly in principle it is possible to follow the chains back and we try to do that wherever we can.

**Q88 Mr Davidson:** In these circumstances do the tax stamps designed to deal solely with sales through corner shops and the like not seem a disproportionately expensive way of tackling this?

**Mr Eland:** No, I do not think so, given that what we are really looking to do there is drive out this whole means of illegal distribution. If we can get that 80% substantially down then it forces the smuggling gangs to distribute the product in a much more high risk and vulnerable way for us to tackle it. We do see it as a very central part of what we are trying to do.

**Q89 Mr Field:** May I follow what Ian was saying about the chain from production to consumption? Can you estimate at what point most of the fraud occurs?

**Mr Eland:** It is difficult to generalise, other than to say that we do think it is diverted either by inward diversion or outward diversion sources and goes into wholesale distributors, cash-and-carries, that type of activity.

**Q90 Mr Field:** I do not understand that answer. Does not most of the product go to warehouses?

**Mr Eland:** Yes. It comes out of the warehouse and is then an outward diversion, which would mean it would simply be diverted from a UK warehouse into the illegal distribution chain, or it would be imported and similarly diverted.

**Q91 Mr Field:** That would be a case, would it not, for what Brian Jenkins said about levying the tax at the point before it disappears?

**Mr Eland:** If you took it back you would clearly take out some of the middle part of the chain, but you could still get a diversion where goods have gone for export, which obviously have to be free of tax and can be brought back in as an inward diversion. There are ways round that.

**Q92 Mr Field:** Obviously not for that group, but for the other groups where it is for internal consumption without going abroad first, if the tax were levied at the point of production and people claimed it back, if it were legitimate for them to do so, then it would not matter where it went off the rails, would it, because the tax would be in your hands?

**Mr Eland:** You would still have to watch the exports coming back, but yes, it could have an effect of the sort you are talking about.

**Q93 Mr Field:** Is that not the sort of scheme the government rather likes because it puts the cost of administering the tax on somebody else? They just say "You pay the tax. You can now get it off the supply chain as the alcohol moves down".

**Mr Eland:** It is not foolproof for the reasons I have given. It will also impose quite significant costs on the industry, far more than tax stamps.

**Q94 Mr Field:** Are you saying the costs would be greater than the fraud?

**Mr Eland:** I do not know that precise balance, but I am saying that it would impose significant costs on the industry, greater than the costs imposed on the industry through tax stamps.

**Q95 Mr Field:** It would actually reduce costs for tax payers who have to pick up the loss of tax which is fraudulently occurring at the present time.

**Mr Eland:** It would reduce one type of fraud, but there would still be opportunities for that fraud to be displaced into other activities and we do see here that where we are successful in one area such as tackling smuggling, it then switches to diversion fraud and it moves around as you tackle it.

**Q96 Mr Field:** Of course, but that is not a reason for giving up, is it?

**Mr Eland:** No; certainly not.

**Q97 Mr Field:** May I refer you back to a report this Committee made in the 1997-98 session, where it said that Customs officers dealing with large traders should receive appropriate training. The government launched the counter-fraud professional accreditation board in October 2002. How many officers do you have and how many have been on that government backed course?

**Mr Eland:** I would have to let you have a note on that precise course.<sup>6</sup> What we have been doing is increasing very significantly the numbers of our staff who are given professional tax training. I could let you have the details of that as well, if you would like. We have made significant progress in this area, particularly in the large business group, where we now have over 300 staff who have been through professional training of one kind or another.

**Q98 Mr Field:** That would be 300 out of how many?

**Mr Eland:** That is 300 out of about 600 compliance officers. Auditors are going through different training. It is about 50% of the general assurance staff.

**Q99 Mr Field:** In a later report we suggested that Customs should continue to develop strategies for tackling fraud and report these annually. How many of these reports have you made?

**Mr Eland:** These are the different tax strategies. We have probably made three, maybe four, reports. We tend to do it at the time of the PBR. We have now covered tobacco, VAT and alcohol and we have previously covered oils as well.

**Q100 Mr Field:** Part of that response, not just to doing reports, but reports informing action by you, was what you call the introduction of QUARTZ 2. This occurred in August of last year. When did the National Audit Office tell you that they were going to come to investigate this area?

**Mr Eland:** I am afraid I do not have the answer to that.

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**Mr Suffield:** That would have been in January or February of 2003.

**Q101 Mr Field:** In fact it was well after you had given them notice that you were going to investigate the counter-fraud activities. Something like eight months later you introduced the QUARTZ 2 strategy.

**Mr Eland:** This is in the large business group area.

**Q102 Mr Field:** Yes, the large businesses.

**Mr Eland:** The QUARTZ programme is something where we are moving sector by sector across the tax. The pace of that has been dictated by our assessment of which of the risk areas we ought to be concentrating on.

**Q103 Mr Field:** That is quite a big area, is it not?

**Mr Eland:** Yes. We are trying to get a much better handle on risk down in a business sector, as opposed to our previous approach which has been to concentrate on individual businesses. It is trying to get a macro look rather than just a micro look.

**Q104 Mr Field:** You said earlier, when we previously looked at the public sector's response to countering fraud by looking at the Crown Prosecution Service, that you have a better record than they have. Might we have a note on how much better?

**Mr Eland:** Yes, I will let the Committee have a note on our prosecution statistics.<sup>7</sup>

**Q105 Mr Field:** It is merely a suggestion; it is not a point of criticism. Trying to get the government departments to take fraud even more seriously is a big job and there is no one day when you say you have made these huge gains. To what extent do you think high profile fraud cases which are successful is an important part of trying to develop a culture where people think it is not worth taking the risk?

**Mr Eland:** We would certainly see that in tackling fraud you have to have a credible prosecution part of that. You also have to hit people very hard in their pockets, which is why we would seize the lorry, which is extremely expensive, we would, if appropriate, follow through and try to seize assets of the individuals who had been convicted. We want to make it very clear that not only is there a risk of detection and conviction but that we will hit people's pockets as well.

**Q106 Mr Field:** Do you think there is a bias in the media against trying to help develop this counter fraud culture in that we round this table can remember your failures but I cannot remember seeing a report where you are successful?

**Mr Eland:** You are right that sometimes it is difficult to get publicity for successes but that is because human nature does tend to look for what has gone wrong rather than what has gone right.

**Mr Field:** Bernard Shaw said that if we were promoted from inferno to paradise we would still gather around and talk about the good old days. It appears that is the same for countering fraud.

**Q107 Mr Bacon:** May I first of all say thank you to your staff for arranging the visit to Heathrow which we found very helpful. My first question is about tobacco. It might be helpful if Mr Wells answered it, because he was there when we had Imperial as witnesses. How would you characterise the level of co-operation you are now getting from Imperial? Would you say it is satisfactory? Am I right in thinking you have signed a memorandum of understanding?

**Mr Wells:** We have signed a memorandum of understanding now and the position is substantially improved on where we were when I was previously before you on that issue. You may have seen in our annual report this year that we reported figures on the present breakdown of seizures that we make by brand and the brands belonging to Imperial Tobacco, which were previously dominant in our seizures, are now a relatively small proportion of the whole, which is at least one important element of change which we can demonstrate. There does appear to have been quite a marked shift.

**Q108 Mr Bacon:** Just to go back to my question: how would you characterise the overall level of co-operation? Are you content with their level of co-operation?

**Mr Wells:** At the present time I have no reason to say that I am not, or that I would single them out as being different from others.

**Q109 Mr Bacon:** If I could turn to alcohol, Mr Eland, do you still let loads run in diversion fraud investigations?

**Mr Eland:** Occasionally but in very tightly controlled circumstances. They have to be approved up the hierarchy and I personally have to approve anything over £1 million duty at stake.

**Q110 Mr Bacon:** Is there a level at which—I know London City was by itself about £340 million, from memory—you will say too much money, we will not do this any more?

**Mr Eland:** We would certainly not get into a position where we were seeing what was happening at London City bond warehouse occurring again, no. That is why we have this approval mechanism.

**Q111 Mr Bacon:** Can I turn to the question of tax stamps and your estimates of the industry? Mr Davidson raised the question earlier of the 37% growth in the industry. The Scotch Whisky Association says that you agree that this 37% is what would have been required, but that no-one in the trade sees the market disruption which would result from that kind of fraud on that scale and they are not aware of any government or commercial data which supports the suggestion that there has been that kind of significant growth in the market. Surely it cannot

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<sup>7</sup> Ev16

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be that difficult, using modern sampling techniques, to find out how much whisky is consumed in this country, can it?

**Mr Eland:** We do use those survey results carried out by Defra and the Office for National Statistics.

**Q112 Mr Bacon:** You rely on Defra do you?

**Mr Eland:** They carry out the drink consumption statistics.

**Q113 Mr Bacon:** The 1999-2000 fraud figures you had started off as being £450 million and for that same year were then £500 million and then in December 2003 you announced that they were actually £350 million. It is a very wide variance. How are we to know whether any of these three figures is accurate?

**Mr Eland:** The reason for the change in the figures was as a result of the base being updated after the census of population and a change in the consumption statistics where two surveys had been amalgamated into one. There has been a change in the underlying consumption figures we were given. We still do feel that although you will get changes from year to year as figures are refined, the important thing is the broad overall level and the trend year on year. We are extremely concerned to see the upward trend now shown by these latest figures. We do think that justified taking further action.

**Q114 Mr Bacon:** Are you aware that the Ukrainian authorities quite recently introduced a new state-of-the-art hologram seal to beat counterfeiting of the previous stamp and that forgeries of the new stamp were circulating within three weeks?

**Mr Eland:** No, I had not heard that particular story. Obviously fraud in terms of counterfeiting of the stamp is a concern.

**Q115 Mr Bacon:** When Norway thought of introducing tax stamps in 1997 the Department of Trade and Industry advised them that it would be a bad idea, did they not?

**Mr Eland:** I was not aware that was the case.

**Q116 Mr Bacon:** What I should like to know is what has changed to make that advice now wrong?

**Mr Eland:** I was not aware that advice had been given, but what we have is the experience of other countries in Europe.

**Q117 Mr Bacon:** Which countries? Hungary?

**Mr Eland:** Spain, Denmark, Portugal, Italy.

**Q118 Mr Bacon:** Why not Germany and France?

**Mr Eland:** Because they have not thought that in the nature of their own particular market and problems this is something to do.

**Q119 Mr Bacon:** When the United States removed strip stamps in 1985 the US Treasury said that the stamps had only negligible value in evidence in compliance with the law and payment of excise taxes. Germany does not have them either. Germany

and the United States are very big economies, two of the biggest in the world. Why is it right to ignore them?

**Mr Eland:** It is a matter not of the size of the economy but of the type of problem in relation to fraud which occurs within those countries. Obviously you can quote examples on either side.

**Q120 Mr Bacon:** I do not normally carry a bottle of whisky around in my pocket, but I happen to have one today. You will see, Chairman, that it is in fact unopened. There is a mark on the back of the label here which is imprinted at the distillery, which indicates both the brand and the bottling line and the distillery itself and the cask. I am told you can tell, almost to the minute, if not the second, when this bottled was filled. With that level of detailed information, why are you not using that information, which is already there and has been for years, to do a more effective job in tracking fraudsters?

**Mr Eland:** It does not give the status of the duty which a tax stamp would and enable a retailer to be able to distinguish whether he was being sold a lot of illegally diverted spirit or genuine spirit. We can use that sort of information when we get frauds, to try to track back through records as to whom that bottle has passed through, but that is a different issue to the tax stamp one.

**Q121 Mr Bacon:** Does it not come back to the fundamental question of how much whisky is consumed in the UK? If you know that, you can work out the rest, can you not? Your estimates and those of the industry are widely different.

**Mr Eland:** I do not know whether the industry could tell from that mark precisely how many hands that bottle had passed through. They would know to whom they had sold it.

**Q122 Mr Bacon:** You were saying a minute ago that this does not give the information a tax stamp would. The point I am seeking to make is that if a tax stamp is forged, then that will not either. But, if you have sensible figures for consumption of whisky in the UK—and it appears that currently you do not, or at least you and the industry differ widely on what those are—working that out correctly and accurately would enable you to work out the rest, would it not?

**Mr Eland:** Clearly the best figures possible for consumption would help us all and if anybody wishes to suggest a better way of calculating consumption then obviously we would be very happy to consider that. We do not accept our consumption figures are flawed. We are talking with the industry about these different methods of calculating them.

**Q123 Mr Bacon:** May I direct you to page 33 of the Report and Figure 3.6 talks about what it calls examples of ineffective communication between different parts of Customs and Excise. It refers to one occasion where “Detection staff did not notify investigation staff of their intention to visit a suspect

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site” and in fact the investigation team were only notified of the arrest after it had taken place and therefore there was time to dismantle the distillery and the evidence was removed. In the other “The Regional Business Services team arrived first, and found 330 cases of whisky” but those had been removed by the time the detection team turned up and also a lot of paperwork had allegedly been destroyed. Could that kind of thing still happen? It was three out of 36 cases, which is admittedly not most, but it is still 10%. Is that sort of thing now less likely to happen? Are you making changes in your structures to ensure that you do actually communicate better?

**Mr Eland:** Yes. We have learned lessons from these cases. In both cases there was a post-mortem examination of what had gone wrong. I would just emphasise that although there were flaws in these cases and I do not want to excuse them, we did actually successfully prosecute in both cases. It was not a good story. We have learned lessons from this.

**Q124 Mr Allan:** On the point about the excise warehouses, how many warehouses are there in the UK?

**Mr Wells:** Around 1,100.<sup>8</sup>

**Q125 Mr Allan:** You said earlier that you think the biggest source of fraud at the moment is outward diversion fraud.

**Mr Eland:** It has shifted to that. It is about half and half.

**Q126 Mr Allan:** Outward diversion fraud necessarily involved the complicity of somebody who is running an excise warehouse. Is that correct?

**Mr Eland:** No, it does not have to.

**Q127 Mr Allan:** It could be taken without their knowledge.

**Mr Eland:** It could be a lorry driver or different parts of the chain.

**Q128 Mr Allan:** But somebody in the warehouse must be involved. The stuff is coming out of a warehouse with false documentation.

**Mr Eland:** Obviously if there is false documentation, but that is not the only way.

**Mr Wells:** It is certainly possible for there to be complicity with the warehouse, but it is not essential for a fraud to take place.

**Q129 Mr Allan:** It seems if you stop the fraudsters getting involved with the warehouses that would be a key way of tackling the fraud. You referred to this review of who owns these warehouses. Do you have figures for how many people were actually stopped from running warehouses afterwards as a result of

that? Have you told people that they were out of the business?

**Mr Eland:** Yes, we do.

**Q130 Mr Allan:** Could we have a note on that?

**Mr Eland:** We would need to let you have a note.<sup>9</sup>

**Q131 Mr Steinberg:** May I return to collapsed cases and quote to you from letters I have received from a journal? Perhaps you would explain it to me, because I did not understand what it meant and I am sure you do. A letter came to us all saying that another criminal case had collapsed because of the civil stance of the Customs and Excise in non-economic activity. I do not know what that means at all. Perhaps you could explain that to us.

**Mr Eland:** I am sorry, I cannot.

**Q132 Mr Steinberg:** Then the actual article in the newspaper says “The trial was halted last Monday, 10 November, after the case was dropped by VAT commissioners. Details of the offences were not available at the time of going to press. In a Customs operation code named *Entrée* four men had all charges against them dropped by Customs for undisclosed reasons. A Customs spokesman confirmed that proceedings in Operation *Entrée* were stayed in the public interest. The news comes just a few weeks after Customs lost a VAT trial in Leeds Crown Court when five defendants successfully cited an earlier case relating to a company called Bond House, when it was determined that VAT does not apply to carousel fraud” whatever that means. “However, Customs claimed that the Operation *Entrée* case was halted for different reasons from Operation *Dundee*. Operation *Dundee* fell apart due to the indictment and Customs trying to amend it. Operation *Entrée* never went that far. We cannot go into detail for sensitive reasons. In another current VAT trial code named *Expire* Customs say the defendants are now due for sentencing this Friday, 27 November”. Can you explain?

**Mr Eland:** I cannot give a precise reason for those cases. If you like, I could let you have a note on that.<sup>10</sup> Sometimes cases have to be withdrawn in circumstances where there is a danger of exposing an informant or something else.

**Q133 Mr Steinberg:** What is a carousel?

**Mr Eland:** The carousel frauds are VAT missing trader frauds where there is a movement around between different European countries and it is called a carousel. From the details you have given me, I cannot identify that particular case.

**Q134 Mr Steinberg:** Cases.

**Mr Eland:** If you like, I can add that to this note we are doing on prosecutions.

**Mr Steinberg:** Yes, if you would. Fine.

<sup>8</sup> *Note by witness:* There are currently 756 Excise warehouses. In addition, there are 790 other tax warehouses able to produce, hold, receive and despatch duty suspended goods, making a total of 1,546 tax warehouses.

<sup>9</sup> Ev16

<sup>10</sup> Ev17-18

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**Q135 Mr Davidson:** I wish to follow up the point Mr Bacon made on the number on the bottle, which I had overlooked as I do not drink from the bottle. Does the number on the bottle enable you to clarify whether or not tax has been paid once you go back and consult the records?

**Mr Eland:** I am not sure whether the industry would be able to trace through a bottle which maybe had passed through many hands. This is something we should be perfectly happy to explore with them and if they say that this can give us everything we want, then it meets the Chancellor's criteria of an alternative to tax stamps. I suspect it will not do that, because I do not think it does give the information about the duty status.

**Q136 Mr Davidson:** That would presumably give you traceability by following it back through the process. I understand that it is not instantaneous recognition that tax has been paid or not paid. By following it back through the chain or going back to the source you would be able to identify whether or not tax had been paid.

**Mr Eland:** You might be able to say it had been manufactured at a particular distillery. You would not necessarily be able to say what had happened to it after it had left that distillery. This is the point I am making.

**Q137 Mr Davidson:** Just coming back to Mr Wells' point about the seizures where one in two were false and there were difficulties about following the paperwork back up. Given that you had coded a bottle, you would presumably also be able to follow it downwards and that is coming back to the point about choke points, is it not? There are several recognisable choke points where you would be able to identify from where it had been diverted. Is that not correct?

**Mr Wells:** You are right, but of course the bottling process enables you to track from the top, but spirit can pass through many hands, many owners, and it does not enable you to follow the chain beyond that initial point of sale, particularly if product has circulated around a number of countries and been through a series of owners over a long period of time and at some point in a fraudulent chain, of course, will be the fraudster who may well be a fictitious company.

**Q138 Mr Davidson:** Yes, but we have to some extent already covered this ground here when we were looking at tobacco, have we not? We were talking about the equivalent of "Know your customer" and millions of cigarettes were going into Moldavia or Kaliningrad or somewhere similar. We were saying that there was an obligation on the company to clarify for their own purposes that there was a genuine end user. Presumably the same rules could be applied here and it would overcome some of this to some extent.

**Mr Wells:** In the alcohol industry the producers tend to be somewhat more distant from the market than is the case in tobacco where there is a relatively smaller number of companies. Clearly if the manufacturers were to take on the task of policing the entire chain of alcohol sales, then that would become more of an issue. That is not the way the industry is structured at the present time.

**Q139 Mr Bacon:** The Scotch Whisky Association in its brief says that companies have sophisticated traceability systems. I am sure they are much better than those of the Ministry of Defence. If they are approached by Customs and Excise, they can assist in tracking exactly where in the supply chain fraud has occurred, to the extent that distilleries can identify where bottles have been removed. If 200,000 illicit bottles a day are being sold, which is what I believe you agreed would be required for this level of fraud to be correct, it is hard to understand why there is not frequent tapping into distillers' willingness to assist. A stream of Customs and Excise inquiries would be expected. This has not happened. Why not?

**Mr Eland:** I am really going to have to repeat myself, that I do not believe that information does give the full duty picture. You are saying that of that number they can track every single transaction which has happened in relation to that bottle from start to finish.

**Q140 Mr Bacon:** No, I do not think that is what they are saying. What they are saying is that because their traceability systems are quite sophisticated—and we all know about the problems the MOD have of finding out where their stuff is—and the fact that commercial supply chain software has been around for years which is capable of doing this, if the level of fraud is what you say it is, they would have expected you to have approached them to ask for their assistance in identifying where in the chain the alcohol has been removed, indeed they would have expected a stream of inquiries from Customs and Excise. That is not what they have had and they wonder why not.

**Mr Eland:** Because we have not considered that information as something we needed in order to be able to take action.<sup>11</sup>

**Q141 Mr Bacon:** Surely to goodness what you need is the most sophisticated understanding you can get of the supply chain.

**Mr Eland:** We are extremely ready to use this information.

**Q142 Mr Bacon:** Here they are, offering it.

**Mr Eland:** We have been having talks with the industry over the last year. I am not aware they have

<sup>11</sup> *Note by witness:* When large seizures are made, where appropriate Customs do use the information contained in the product code to track and trace its origin.



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suggested this in the course of those talks as being something which is going to solve our problems.

**Q143 Mr Bacon:** If they have not yet, I am sure they will be doing so soon.

**Mr Eland:** We have been looking precisely through the talks we have had with them for information which will help us in tackling fraud.

**Q144 Mr Bacon:** May I now ask the question I was going to ask which relates to the level of losses. In the report last year—and I have been looking for comparable figures this year and could not find them; perhaps they are there and I have missed them—it said that Customs believed that VAT in total, although it is difficult with any precision to quantify the tax paid through error, evasion or avoidance, was between £7.1 billion and £10.2 billion and that your latest estimates are that for taxes and duties on alcohol, tobacco and hydrocarbons it was a further £7.1 billion. Could you say what the most up-to-date figures are for each of those now?

**Mr Wells:** The most recent figures are published in the document which was published at the time of the Pre-Budget Report prior to Christmas. If it would be easiest, I can provide you with figures for each category.<sup>12</sup>

**Q145 Mr Bacon:** Yes, that would be very kind. I should just like to get the comparable figures for the ones in last year's Standard Report.

**Mr Eland:** We will let you have those.

**Chairman:** Gentlemen, thank you for an interesting hearing. I am sorry, Mr Hanson, you had a bit of a quiet afternoon, although the work you do is very important. We are told that the largest 1,000 businesses in the UK contribute 34% of VAT revenue, £22 billion. However, I am afraid we have spent pretty well the entire afternoon talking about the interesting issue of fraud on alcohol, which you believe may be as high as £650 million per year but you are not entirely sure. We have also had a very interesting discussion on tax stamps and that is clearly something which is going to exercise Members of Parliament greatly. Thank you for assisting us today.

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<sup>12</sup> Ev18

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**Supplementary memorandum submitted by HM Customs and Excise**

QUESTION 67 (MR STEINBERG):

**PROSECUTION CASES**

	1998–99		1999–2000		2000–01		2001–02		2002–03	
		%		%		%		%		%
No. cases	1,926		1,969		2,209		2,179		1,845	
No. convictions	1,662	86.29	1,759	89.33	1,896	85.83	1,947	89.35	1,625	88.13
No. with no convictions	109	5.66	89	4.52	115	5.21	113	5.19	114	6.18
Non jury disposals <sup>1</sup>	97	5.04	86	4.37	119	5.39	88	4.04	91	4.93
Other <sup>2</sup>	58	3.01	35	1.78	79	3.58	31	1.42	14	0.76

<sup>1</sup> Number of cases that did not reach the jury either as a result of Customs or the judge stopping the prosecution, for example:

- Cases withdrawn where we have offered no evidence or stayed proceedings;
- Cases where the judge has ordered an acquittal;
- Cases where the judge has directed an acquittal;
- Cases that lie on file;
- Cases that have been dismissed by a Magistrate;
- Cases where the defendant has been discharged before evidence was heard; and
- Cases where the defendant has been discharged after evidence has been heard.

<sup>2</sup> Includes both defendants who have absconded and those about whom we do have accurate information.

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QUESTION 97 (MR FIELD):

The counter fraud professional accredited training is most suitable for investigators of internal departmental or internal business fraud. All Customs Internal Investigation Division staff have therefore undertaken this training—22 staff to date.

The comment from the Committee in the 1997–98 review related to the improvement of audit and legal training. Following that review all large business assurance staff underwent specific Large Trader Advanced Accountancy and Audit training (LTAAT).

Subsequently Large Business Group training has further developed audit and legal training. Currently over half of our technical assurance staff have undergone the advanced, professionally accredited, legal and tax training which succeeded the LTAAT courses, and this programme is continuing. All of our computer audit staff who have now transferred into the Audit Service have undergone computer systems audit training. This training is now externally accredited and, as we develop a separate Audit Service to utilise the specialist audit skills of those staff, we shall put all new audit staff through this training programme.

The training we now provide for Large Business Group staff is clearly focused on the professional approach we need to counter avoidance and legal challenges. Staff are trained in fraud recognition as part of foundation VAT training. If major frauds are identified, then Large Business Group staff will involve our Law Enforcement specialists.

QUESTION 104 (MR FIELD):

Direct comparisons between the returns in Customs prosecutions and those achieved elsewhere in the criminal justice system are not possible in all areas and care is needed because different methods of calculation are often used. Nevertheless, the following comparisons may be made based on Customs data for 2002–03 (*Solicitor's Office SOLAR data, unpublished, SO*) and the *Criminal Statistics for England and Wales 2002 Cm 6054 (CSEW)* and the *Crown Prosecution Service Annual Report for 2002–03 (CPS)*. The focus is on the Crown Court:

- The official statistics record that the percentage of defendants pleading guilty at the Crown Court was 65% (*CSEW, p64, Table 3C & p65, para 3.29*); in Customs cases the figure was 70% (including those committed for sentence by the magistrates) (*SO*). The CPS return for 2002–03 was 73% (*CPS, p32, chart 9*).
- The percentage of those pleading not guilty, who were convicted, was 39% (*CSEW, p65, para 3.30*); in Customs cases it was 63% (*SO*). The CPS return was 16% (*CPS p32, chart 9*).
- If guilty pleas and convictions after trial are taken together, the CPS achieved a conviction rate of 90%; the Customs return was 92% (again, including those committed for sentence) (*CPS, p 32, chart 9 & SO*).
- Of those defendants acquitted following a not guilty plea, some were acquitted at the direction of the judge where no evidence was offered. This proportion was 36% (*CSEW, p 65, para 3.31*); in Customs cases it was 11% (*SO*). The CPS return was 19% (*CPS, p 32, Chart 10*).

*Comment*

In relation to defendants pleading guilty at the Crown Court, the figures for the CPS and Customs are comparable, with the CPS return 3% higher.

There is a marked distinction between the figures for conviction after trial: 63% in Customs cases and 16% in CPS cases.

A greater proportion of CPS cases were stopped on the direction of the trial judge, 19%, as against 11% in Customs cases.

## QUESTIONS 129–130 (MR ALLAN):

A. *Traders/premises already approved (April 2003 to December 2003)*

Existing Warehousekeeper authorisations (revocations)	25
Existing warehouse premises approvals (revoked)	46

B. *Applications for warehousekeeper authorisation/premises authorisation (April 2003 to November 2003)*

Applications for Warehousekeeper authorisation (rejected)	15
Applications for warehouse premises approval (rejected)	7

## QUESTION 132 (MR STEINBERG):

*The nature of VAT Missing Trader Intra-Community (MTIC) fraud*

Changes made to the VAT system in 1993 in order to provide a more seamless Single Market removed the concepts of “imports” and “exports” for intra-Community trade. Instead, goods moving between EU member states are sold VAT free by the “exporter” and declared on the VAT return of the acquiring “importer”. The changes, whilst simplifying the VAT system, opened the door to an opportunity for fraudsters.

MTIC fraud is a EU-wide systematic attack on the VAT system orchestrated, in the main, by sophisticated criminals. The main steps in the fraud are:

- obtaining a VAT registration;
- purchasing goods from a VAT-free source elsewhere in the EU;
- selling them on the domestic market at a VAT-inclusive purchase price; and
- going missing without paying to Customs the VAT due (hence “Missing Trader”).

This basic variant of the fraud is commonly known as “acquisition fraud”. It often involves items that are moved in high volumes, such as soft drinks and confectionery. A development of this fraud, known as “carousel fraud”, involves the continuous movement of goods between traders in different EU member states, resulting in multiple tax losses.

In a UK “carousel” fraud, the initial steps resemble those of acquisition fraud, set out above. However, the goods imported into the country will eventually be re-exported, either back to the original supplier country or to another EU member state. Typically there will be a number of companies in the UK supply chain, increasing the distance between the UK missing trader and UK exporter and making detection more difficult. Goods that are easily traded and have a high value and low volume, such as mobile phones and computer chips, are particularly attractive to MTIC carousel fraudsters.

Carousel fraud is the most abusive variant of MTIC fraud because it can be repeated several times with the same goods. Sometimes, goods can even arrive, depart and return to the UK on the same day and the carousel can operate either through the original EU supplier or another EU business in the same or a different EU State. Annex A provides an illustration of a simple carousel fraud.

*Bond House Tribunal decision and “no economic activity”*

This decision of the VAT and Duties Tribunal established new and important principles in VAT law. It ruled that the where the same goods are repeatedly circulated around a supply chain without being sold to an end user, and where the only purpose is to steal the VAT (that is, there is a missing trader in the supply chain), the transactions within a carousel do not have “economic substance” with the meaning of the EC 6th VAT Directive and, therefore, are outside the scope of VAT.

This means that:

- the circular movement of the same goods within a carousel do not have economic substance and, therefore, will not attract VAT;
- there will be no VAT to account for to, and no VAT to reclaim from, Customs; and
- Customs are, therefore, entitled to deny VAT repayment claims in these cases even if a sum purporting to be VAT has been charged on an invoice.

In the light of this judgement, Customs has reviewed all its prosecution cases in order to ensure that the proper and appropriate charge is put before the Court. In criminal cases involving “carousel” fraud, indictments have been amended to take account of the fact that in cases where there is “no economic activity” there cannot be a charge of VAT evasion under section 72 of the VAT Act 1994. Instead a charge of “cheat the revenue” is the appropriate one for the indictment.

*Operation Dundee, Operation Entrée and Operation Expire*

The first two cases referred to in the press article are distinct cases and the reasons for their discontinuance are not connected. The third case referred to was successfully carried through to conviction:

- (i) *Operation Dundee* was an MTIC fraud case involving mobile phones. At a pre-trial hearing on 18 August 2003, Counsel for the Crown attempted to amend the indictment from VAT evasion under Section 72 of the VAT Act 1994 to “cheat the revenue”.

Counsel for the defendants submitted that the law following the Bond House decision was clear. As the Crown argued that it was a simple missing trader fraud rather than a “carousel” fraud, Bond House would not apply. This in turn meant that the indictment was not flawed and so could not be changed under Section 5 of the Indictments Act. The Judge agreed with the defence and dismissed the application to amend the indictment.

On 22 September, the trial proper began and the first legal argument put forward by the Defence was that this was a “carousel” fraud, that the Bond House decision therefore applied, and that the indictment should be quashed.

The Judge agreed as the Crown could not show that this was not in fact part of a larger carousel fraud. Accordingly there was no economic activity in this case, the amounts charged as VAT were not VAT and that VAT evasion under Section 72 of the VAT Act could not safely be put before the jury. The indictment had to be quashed and the defendants found not guilty with no avenue for appeal against this judgement.

Customs has reviewed all its prosecution cases in light of this judgement in order to ensure that the proper and appropriate charges are put before the Court.

- (ii) *Operation Entrée* was an MTIC case involving mobile phones in which the Commissioners stayed the proceedings. The Commissioners have the power to stay proceedings and these powers are exercised in cases where the prosecution lawyer considers that there is sufficient evidence of an offence to take the proceedings before the court but that the prosecution should nevertheless not proceed on the grounds of the wider public interest.

It is the Commissioners’ policy not to provide reasons for staying an individual case because there are often sensitivities surrounding the case which by their very nature are not in the public interest to disclose—eg, where a judge has ordered the disclosure of intelligence material in circumstances where disclosure may identify Customs’ sources or prejudice an ongoing investigation.

However, in this particular case the decision to stay had no bearing on the Bond House decision. Any decision based on the impact of a Tribunal ruling would be an evidential one and where the prosecution lawyer considers a case fails to meet the test of evidential sufficiency Customs action would be to offer no evidence as opposed to staying proceedings.

- (iii) *Operation Expire* was a MTIC case involving supplies of mobile phones. There was only one defendant (Monmohan Singh Sandhu) and he was convicted on 28 October 2003 on the indictment of cheating the public revenue in a fraud which cost the Exchequer around £16 million. The sentencing in this case has been adjourned until 16 April, so that both sentencing and the confiscation hearing can be dealt with at the same time.

QUESTION 144 (MR BACON):

Details of the latest Revenue Loss figures are published in the attached document “*Measuring and Tackling Indirect Tax Losses 2003*, published in December 2003”.<sup>1</sup>

11 March 2004

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<sup>1</sup> Not printed. <http://www.hmce.gov.uk/forms/budgetnotices/pbr-2003/meas-ind-tax-loss-03.pdf>