



House of Commons
Committee of Public Accounts

Tackling VAT fraud

Thirty–sixth Report of Session 2003–04

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

*Ordered by The House of Commons
to be printed 28 June 2004*

HC 512

Published on 29 July 2004
by authority of the House of Commons
London: The Stationery Office Limited

£10.00

The Committee of Public Accounts

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Summary

Introduction

Value Added Tax (VAT) is payable by registered traders on the goods and services they supply. They may reclaim the VAT on goods and services which they purchase. In 2002–03 £109 billion was collected by 1.7 million registered traders and paid over to Customs. £45 billion was repaid to businesses that had paid more VAT on purchases than they had collected on sales, resulting in net VAT receipts of almost £64 billion.

Traders may not pay the correct amount of VAT for a number of reasons including error, deliberately understating their VAT liabilities or through systematic attacks on the VAT system. Customs estimated that VAT lost in 2002–03 due to fraud and error was over £11 billion. The main areas of loss were non-compliance by traders; traders in the shadow economy who do not register to pay VAT; missing trader fraud (where bogus traders buy goods VAT-free from another EU member state, sell them on at VAT inclusive prices and disappear without paying to Customs the VAT collected); and artificial avoidance schemes with no business purpose other than to save VAT.

The Government has set Customs a target to stop the growth in the VAT gap and to cut it from 15.7% of the total VAT that could theoretically have been collected in 2002–03 to 12% by 2005–06. Following a major review of tax policy and administration, the Government has decided to create a new department “HM Revenue and Customs”, to combine the work of Customs and the Inland Revenue.¹

On the basis of a Report by the Comptroller and Auditor General,² we took evidence from Customs on the scale of losses; preventing and detecting fraud and other non-compliance; and investigating and dealing with fraudsters.

1 *Financing Britain's Future*, HM Treasury Press Notice 17 March 2004 (Cm 6163)

2 C&AG's Report, *Tackling VAT fraud* (HC 357, Session 2003–04)

Conclusions and recommendations

- 1. Customs' work to measure the losses from fraud and error on VAT is an important first step in determining the size and nature of the problem, as well as providing a benchmark for judging progress.** Customs produces annual estimates for missing trader fraud but only has one-off estimates, made in 2001–02, for the other three main areas of loss. It should regularly update these estimates, so that it can assess progress in tackling the different types of loss, alongside progress in meeting its overall target.
- 2. Customs needs better information to determine the most effective response to non-compliance by traders.** Between £2.5 billion and £4 billion a year is lost through non-compliance by traders. But Customs has no estimate of the breakdown between genuine errors, which might be remedied through education campaigns, and more serious abuse calling for punitive action. Customs should therefore conduct a pilot investigation, drawing on the experience of the Department for Work and Pensions, to produce broad estimates of fraud and error to help judge the balance between education and advice, and investigations and sanctions.
- 3. Better use of data matching with the Inland Revenue is needed to detect traders who are evading VAT by operating in the shadow economy.** Customs' joint working with other departments has had some success in detecting traders who should be registered for VAT. But Customs has so far made little use of data matching with records held by the Inland Revenue. The recent review of the Revenue Departments confirmed the scope for greater data sharing, and recommended that the Treasury and the new revenue department should bring forward legislation to allow best use of information in the new department.
- 4. Prompt exchange of accurate and up to date information on traders with other member states is particularly important in tackling missing trader fraud.** The European Commission has announced a feasibility study with the aim of modernising the current EU-wide VAT Information Exchange System to enable more rapid and effective exchange of information on intra-community trade. Customs should work closely with the Commission in devising proposals for the new system to address the inaccuracies and delays in exchanging data experienced with the current system.
- 5. The scale of VAT losses suggests that more investigations and prosecutions for all types of VAT fraud would be cost effective.** Customs prosecutes around 90 VAT fraud cases a year and the number of investigations resulting in civil evasion penalties has fallen to around 270 cases. In the many other cases where Customs finds under-declarations of VAT but does not launch an investigation of the trader, the maximum penalty is 15% of the amount mis-declared. Customs should analyse the level of repeat offending by traders to consider whether the number and level of penalties for under-declarations and for civil evasion should be raised to create a greater deterrent.

6. **To achieve the maximum effect from prosecutions for VAT fraud, court time should be made available promptly so that cases are brought to trial more quickly.** It can take up to a year for court time and lawyers to become available to try a complex VAT fraud case. Customs and the Department of Constitutional Affairs need to finalise and implement their proposals for reducing the delays. Once new arrangements are in force Customs should assess the effect on the time taken to bring cases to trial.
7. **Despite the thousands of under-declarations of VAT discovered each year Customs has only reported the accountant or other professionals involved to their professional body on four occasions.** Only 24 VAT investigations have been in cases where professionals such as accountants, lawyers and tax advisers were involved. Customs should make greater use of such sanctions, working with the business community and professional bodies concerned to agree criteria for reporting and the remedial action expected.
8. **To maintain public confidence in the standard of investigations, Customs' training needs to match standards of good practice applied in the wider profession.** In response to our predecessors' earlier Report on *Checking large traders' VAT liability* (HC 445, Session 1997–98) Customs introduced externally accredited training for internal investigators and staff carrying out assurance work on large traders. It now plans to extend external accreditation of its training, and externally recognised qualifications, to all investigation staff. It should set a timetable for achieving accreditation and milestones for progressively increasing the number of investigation staff holding externally recognised qualifications or in accredited training.

1 The scale of losses

1. Value Added Tax (VAT) is payable by registered traders on the goods and services they supply. They may reclaim the VAT on goods and services which they purchase. Traders are required to register for VAT if their turnover of 'taxable' goods and services exceeds £56,000 in the previous 12 months or is expected to exceed this amount within 30 days. In 2002–03 £109 billion was collected by 1.7 million registered traders and paid over to Customs. Customs repaid £45 billion to businesses whose VAT on purchases exceeded the VAT they collected on sales. The net VAT receipts of almost £64 billion, accounted for just over 58% of the total tax revenue Customs collected.³

2. In 2002 Customs estimated for the first time the total losses from fraud and other non-compliance on VAT. The estimate increased from £10.6 billion in 2001–02 to £11.9 billion in 2002–03 — around 60% of the total losses on all duties that Customs collects. Using operational data, Customs also produced estimates of the different types of loss in 2001–02 (**Figure 1**). Customs has estimated that the loss due to missing trader fraud fell to between £1.65 billion and £2.64 billion in 2002–03, but has not updated the estimates of other types of loss.⁴

3. The loss of £11.9 billion in 2002–03 was equivalent to 15.7% of the amount that could have been theoretically collected in the absence of any losses (known as the VAT gap). The Government has set Customs a target of reducing the VAT gap to 12% by 2005–06. Customs expects to achieve the target through a strategy of deploying an additional 1,000 staff by 2005–06 to secure additional revenue of £2 billion a year. Although the VAT gap calculation for 2003–04 has yet to be completed, Customs believes the gap is closing because receipts have been well ahead of forecast.⁵

4. The effect of the rate of tax on the level of loss is hard to judge as the UK rates of VAT have been stable for some time. Customs believes that when the rate increased in the 1970s and 1980s there was an increase in avoidance as it became more lucrative. In terms of international comparison, Customs considers that the level of fraud depends as much on the nature of society and the economy as the rates of VAT in force. For example, the Scandinavian countries which have higher rates of tax do not have the same scale of fraud although they do suffer some serious fraud, including missing trader fraud.⁶

3 C&AG's Report, paras 1.2–1.3

4 *ibid*, paras 1.5–1.6, 3.7 and Figures 2 and 19; Qq 41–43, 72

5 C&AG's Report, para 1.11; Qq 2, 4–6, 39, 44, 76, 85–87, 114

6 Qq 100–101

Figure 1: Analysis of losses on VAT

Area of loss	Customs' estimate of loss in 2001-02 (£billion)
Non-compliance by traders in paying the right amount of VAT at the right time either because of genuine mistakes or where they deliberately understate a portion of their sales or inflate the value of purchases to reduce their VAT liability.	2.5 to 4
VAT missing trader fraud where traders register for VAT, buy goods VAT free from another EU Member State, sell them on at VAT inclusive prices and then disappear without paying the VAT due to Customs.	1.77 to 2.75
Traders failing to register to pay VAT where their turnover exceeds £56,000 a year.	0.4 to 0.5
Customs do not consider it acceptable for businesses to use VAT avoidance schemes, which are artificial and have no other business purpose than to save VAT.	2.5 to 3
Total estimate for different types of loss in 2001-02	7.17 to 10.25 billion
Top-down estimate of loss in 2001-02	10.6 billion

Note: The top down estimate is based on the difference between actual VAT receipts and the total level of expenditure in the economy that is theoretically liable for VAT, using data from the Office for National Statistics. The estimates for different types of loss are based on Customs' operational data.

Source: C&AG's Report, paras 1.5-1.6 and Figure 2

2 Preventing and detecting VAT fraud and non-compliance

5. Customs launched its VAT Compliance Strategy in April 2003, with the aim of encouraging voluntary compliance by supporting those businesses trying to comply while cracking down on those who abuse the VAT system. The Strategy targeted four areas of loss: general non-compliance; failure to register; missing trader fraud; and tax avoidance.⁷

Preventing fraud and non-compliance

6. Customs estimated that between £2.5 billion and £4 billion was lost in 2001–02 from general non-compliance by traders. The losses covered a wide spectrum, arising from genuine mistakes, carelessness or negligence by traders or from traders deliberately understating their sales or falsely inflating the value of purchases to reduce their VAT liability.⁸

7. Customs had not split the estimate of losses between fraud and error but recognised the need to develop this aspect of its work. The estimate was based on checks on a statistically representative sample of traders and it was difficult to determine whether suppression of activity constituted fraud, because of the need to prove criminal intent.⁹ The Department for Work and Pensions produces separate estimates for losses of welfare benefits arising from fraud and from customer error. In reviewing cases, some may be classified initially as high suspicion of fraud and further work carried out to reach a firm conclusion. Any remaining high suspicion of fraud cases are excluded from the final estimates of fraud.¹⁰

8. Customs is seeking to distinguish more clearly between businesses that have genuine difficulty in understanding the rules and those that deliberately break the rules. It plans to target education on selected groups within the business community to increase awareness and support voluntary compliance, contacting all businesses within the first year of registration, ideally when the first VAT return is due. All businesses already registered before April 2002 are to be contacted by the end of 2004–05. It has also set up compliance management teams to offer guidance to businesses throughout their lifecycle.¹¹

9. Customs became concerned about missing trader fraud in 1999, estimating that it was increasing by between £450 million and £750 million a year. Missing trader fraud involves a trader purchasing goods free of VAT in another EU member state, selling them at VAT inclusive prices in the UK, and then disappearing without paying the VAT over to Customs. Other traders in the supply chain, who might be legitimate traders, can reclaim from Customs the VAT they pay so that the Exchequer suffers a loss. Carousel fraud is a variant where the goods are sold through a series of contrived transactions to a trader in

7 C&AG's Report, para 1.10; HM Customs and Excise, *Spring Departmental Report 2004*

8 C&AG's Report, Figure 2

9 *ibid*, para 1.8; Qq 13–14

10 C&AG's Report, *Tackling benefit fraud* (HC 393, Session 2002–03) Appendix 3; Department for Work and Pensions, *Fraud and error in Income Support and Jobseeker's Allowance* April 2001– March 2002

11 C&AG's Report, paras 2.6–2.7, 2.38

another member state who then sells the goods back to the UK, allowing the fraud to be repeated using the same goods. Such frauds can amount to millions of pounds and are often perpetrated by organised criminal gangs.¹²

10. To prevent missing trader fraud, Customs has introduced more stringent checks on applications for VAT registrations. In 2002–03 Customs carried out additional checks on 2.8% of the 250,000 applications received. As a result around 1.5% of applications were refused or had conditions attached, such as requiring a trader to provide financial security. The number of refusals increased in 2003–04, but increasingly fraudsters have been stealing the registration numbers of existing legitimate traders.¹³

11. Missing trader fraudsters exploit the European Community's VAT arrangements, which are designed to ensure VAT is paid in the member state where goods are consumed. Other member states also experience this type of fraud. Customs saw the main risk from enlargement of the European Union as being in those countries that bordered the accession countries. Together with other member states it was providing advice to new members on their experience of missing trader fraud.¹⁴ The European Commission was sponsoring a programme of seminars, exchanges and study visits to help the new member states adopt as soon as possible the same levels of control efficiency and cooperation as existing member states.¹⁵

Detecting fraud and non-compliance

12. To detect non-compliance and deter fraud by traders, Customs audits the systems of the 1000 largest traders and uses risk criteria to select small and medium-sized traders for audit either through desk-based enquiry, phone call or a visit. Large businesses receive particular attention because of the sums involved and because the complexity of the companies' trading activities and accounting systems creates a higher concentration of risks to the revenue than is found in the general trader population. Large businesses account for less than 0.1% of the total trader population but around a third of the net VAT collected, £21.3 billion in 2002–03. Customs identified net additional liability of £1.06 billion from checks on large businesses and £2.2 billion from checks on small and medium sized traders in 2002–03.¹⁶

13. This Committee's 21st Report of Session 2002–03 concluded that in planning visits to traders, Customs should have regard not only to the risk of fraud and evasion, but also to the wider risk of misunderstanding even by compliant traders, and the need for advice and guidance as well as enforcement activity.¹⁷ The Committee saw scope for Customs to increase the revenue yield by visiting a significantly higher proportion of traders. In response Customs agreed that increased contact with traders whether by a visit or office

12 C&AG's Report, paras 3.1, 3.5, 3.7; Qq 7–8, 20–24

13 C&AG's Report, paras 3.8–3.9; Qq 7, 25–28

14 C&AG's Report, paras 3.2; Qq 7–9

15 Report from the European Commission to the Council and the European Parliament, COM(2004)260, 16 April 2004

16 C&AG's Report, paras 2.5–2.6; Qq 62, 80

17 21st Report from the Committee of Public Accounts, *The operations of HM Customs and Excise in 2001–02* (HC 398, Session 2002–03)

based contact could increase revenue yield and in 2003, launched a new approach to improve VAT yield and target activity more effectively.¹⁸

14. Customs' performance pay system provides for bonuses to be paid to better performing staff but these bonuses are not linked to the amount of fraud detected. Performance pay is instead based on an annual assessment of an officer's achievements against operational objectives and targets that take account of experience and training, so as not to raise doubt about an officer's impartiality in raising taxation.¹⁹

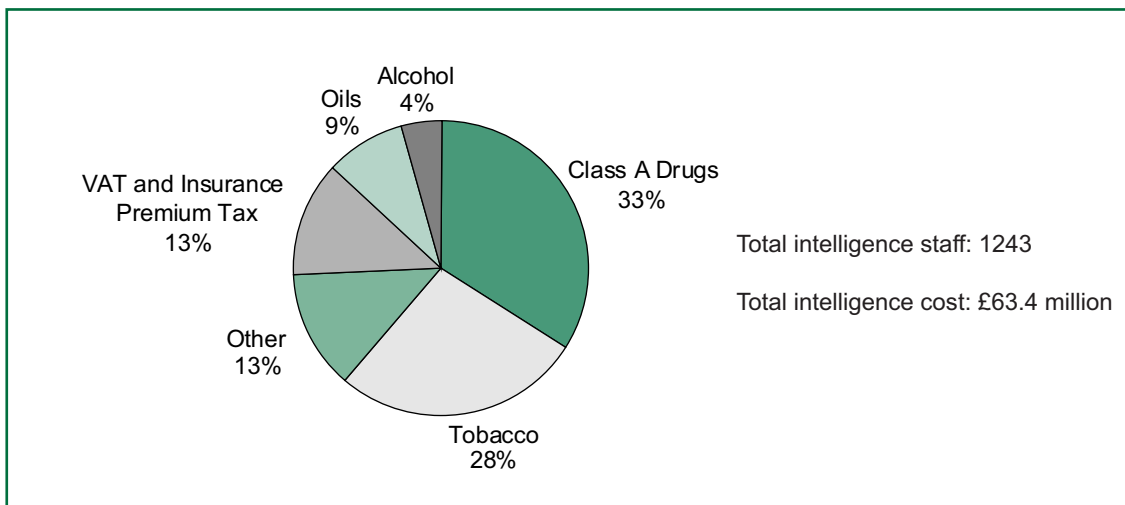
15. Customs uses specialist intelligence staff to identify the business sectors and trader characteristics which present the greatest risks to revenue, and the methods used by criminals to defraud VAT. The proportion of those staff allocated to intelligence work on VAT had decreased from 16% in 2001–02 to 13% in 2002–03 and 2003–04, following reorganisation and redeployment of some staff to tobacco smuggling. The 13% of intelligence resource allocated to VAT (**Figure 2**) was proportionately much less than its share of the tax receipts involved. Customs considered that intelligence work on other duties involved the detection of smuggling which was more labour intensive than work on VAT where Customs could make greater use of data interrogation, and draw on intelligence gained from analysis of trader returns and its assurance work. Customs did not have a specific process by which its planned intelligence outputs were translated into deployment decisions and resource allocations, but it was looking to address this weakness.²⁰

18 Government Reply to the 21st Report from the Committee of Public Accounts (Cm 5961); C&AG's Report, para 2.7

19 Qq 84–90, 132–137

20 C&AG's Report, paras 2.9– 2.11; Qq 31–37, 129

Figure 2: Allocation of intelligence resources in 2002–03



Source: HM Customs and Excise
Source: C&AG's Report, Figure 5, p15

16. Customs estimates that around £0.5 billion a year is lost in VAT from between 125,000 and 180,000 traders who should register to pay VAT but fail to do so. Some may operate in the shadow economy unknowingly but some do so deliberately. Such traders may also be evading direct taxes payable to the Inland Revenue while individuals who work for cash may also be claiming welfare benefits fraudulently. Customs, with the Inland Revenue and the Department for Work and Pensions, has created Joint Shadow Economy teams to share information and conduct joint investigations. Through this work Customs secured 3,600 VAT registrations in 2002–03, estimated to be around 3% of those operating in the shadow economy.²¹

17. In 2003 Customs also ran a one-off incentive scheme to encourage traders not registered for VAT to come forward. Such traders would not incur penalties if they cooperated in establishing the VAT due, paid any arrears in full and made their returns and payments on time for a year after registration. This resulted in a further 3,900 registrations, and payment of £26 million of arrears, and after the end of the scheme, there was a continuing increase in registrations and arrears.²² Customs plans to publish a full evaluation of the scheme during 2004.²³

18. Customs is also conducting an exercise to match selected Inland Revenue data with its own database of traders to identify unregistered businesses trading above the registration threshold. Under the Finance Act 1972 the departments were not permitted unrestricted access to each others' databases but restrictions had been modified in recent years and information could be exchanged on a targeted basis.²⁴ The recent review of the Revenue Departments concluded that the creation of a new department provided an opportunity to improve sharing of information across the tax system to target compliance action more

21 C&AG's Report, paras 4.1–4.6, 4.8; Qq 10, 130–131

22 C&AG's Report, paras 4.11; Qq 55–57, 98

23 HM Customs and Excise Departmental Report, Spring 2004

24 C&AG's Report, paras 4.6, 4.12; Qq 11–12, 97

effectively. This review recommended that the Treasury in partnership with the new department should bring forward legislation to allow best use of information.²⁵

19. Cooperation with other EU member states is particularly important in identifying cases of missing trader fraud, because the fraudsters operate across different member states. Customs has bilateral arrangements to exchange information on frauds with some member states. A further mechanism is the EU-wide VAT Information Exchange System—a computerised system for exchanging information on registered traders and intra-Community supplies of goods. But the information is not up to date, is incomplete and sometimes incorrect, and it can take member states up to three months to respond to enquiries, which limited its usefulness. Customs is therefore seeking with other member states to improve the system.²⁶ The European Commission announced in April 2004 a feasibility study aimed at modernising the current system to enable more rapid and effective exchange of information on intra-community trade at less cost to taxpayers.²⁷

20. A further source of loss is VAT avoidance which Customs estimated to cost between £2.5 billion and £3 billion in 2001–02. Depending on how they are implemented, VAT avoidance schemes are not illegal. But Customs do not consider it acceptable for businesses to use schemes which are artificial and have no other business purpose than to save VAT.²⁸ In 2003 the Chancellor of the Exchequer announced various measures to tackle VAT avoidance schemes and close loopholes in the law.²⁹ New disclosure rules were also announced in the 2004 Budget. Businesses with a turnover of £600,000 or more will be required to disclose use of VAT abusive avoidance schemes which appear on a register to be published by Customs. In addition, businesses with a turnover of £10 million or more will be required to disclose details of VAT schemes and other arrangements that meet specific criteria.³⁰

25 *Financing Britain's Future*, Chapter 4 (Cm 6163, March 2004)

26 C&AG's Report, para 3.15; Qq 29–30

27 Report from the Commission to the Council and the European Parliament, *The use of administrative cooperation arrangements in the fight against VAT fraud*, 16 April 2004

28 C&AG's Report, Figure 2

29 Budget Report 2003 and Pre-Budget Report 2003

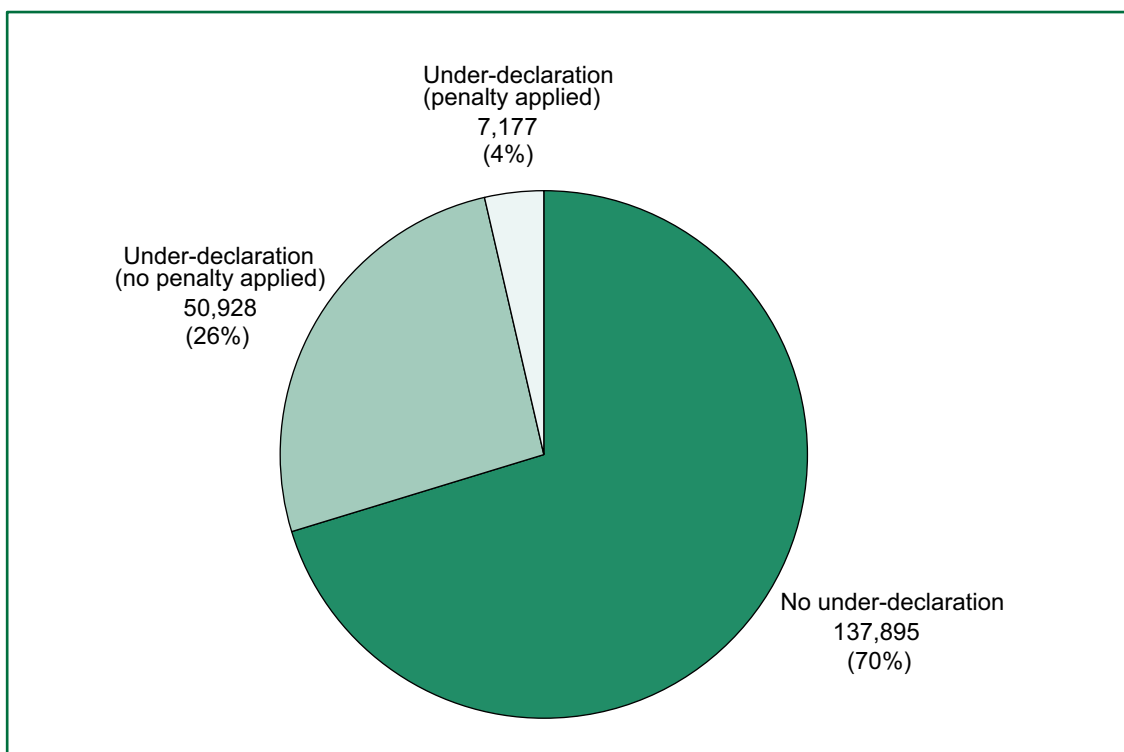
30 HM Customs and Excise Departmental Report, Spring 2004

3 Investigations and sanctions

21. Where Customs identifies, through assurance checks on traders, under-declarations of VAT it may impose a penalty as well as requiring payment of the VAT due and interest. If fraud is suspected Customs may investigate further with a view to imposing a civil evasion penalty or pursuing criminal prosecution.³¹

22. Around 30% of traders under-declare their VAT liability (**Figure 3**). In its assurance work in 2002–2003, Customs imposed penalties amounting to £20.1 million in just over 12% of cases where it found under-declarations by traders. A penalty of up to 15% of the amount of VAT mis-declared can be applied when the errors exceed the statutory limits of 30% of the gross amount of VAT or £1 million in VAT. Customs does not impose a penalty where there is a reasonable explanation such as mistakes because of the complexity of the case, or because of compassionate circumstances or unforeseeable events which affected the business.³²

Figure 3: Under-declarations of VAT liabilities and the use of penalties in 2002–03



Source: C&AG's Report, Figure 4, p16

23. The majority of cases where errors were found were small businesses and sole proprietors, where the errors would have been made by the proprietor or their bookkeeper. The high incidence of under-declarations in bigger cases raised questions about the professional competence and integrity of accountants and others completing VAT returns. Customs discusses with the professional bodies how they can help to improve compliance

31 C&AG's Report, Summary para 15; Qq 59, 117

32 C&AG's Report, para 2.8; Qq 61, 102

through regulatory activity. It can also report serious breaches of professional ethics to the regulating bodies, under guidelines designed to reflect disclosure provisions in data protection legislation. It has done so in four cases. Customs can prosecute if it has evidence of criminal intent. Over the three years to 2003–04 only 24 VAT investigations cases had been undertaken where accountants, legal representatives and tax advisers had been professionally involved. Customs raises at company board level major errors or concerns about the quality of a company's finance division but has done so only in isolated cases.³³

24. Where fraud is suspected, Customs may carry out an investigation with a view to imposing a civil evasion penalty which can be up to 100% of the tax evaded, or pursuing criminal prosecution in more serious cases. Customs has 1,800 investigation staff working on fraud and smuggling cases. Around 18% of staff time was spent on VAT fraud in 2002–03, covering 699 civil investigation cases and 377 criminal cases.³⁴

25. Of the 499 civil investigations completed in 2002–03, 276 resulted in penalties being levied. The penalties imposed amounted to around £7 million representing over 40% of the £16 million revenue evaded. Around half the cases were completed under new procedures introduced by Customs in 2002. Meetings are held instead of formal taped interviews and, where traders agree to co-operate, no investigation is undertaken during the disclosure process. When arrears of VAT have been agreed and accepted by Customs and the trader has fully co-operated, any penalty imposed does not normally exceed 20% of the tax evaded. The new procedures have led to faster completion of cases and payment of the VAT due and fewer appeals.³⁵

26. The number of cases where Customs applied civil evasion penalties fell sharply from 729 cases in 2000–01 to 276 cases in 2002–03 (**Figure 4**). The total value of such penalties also fell as a consequence, although the average amount rose from £37,000 to £59,000 reflecting Customs' targeting of more serious cases. The trend also reflected Customs' reallocation of staff to criminal investigations to which they were giving higher priority because of the greater sums involved. To compensate for the reduction in civil evasion penalties, Customs is following up on cases as part of its assurance work to impose mis-declaration penalties of up to 15% of the tax.³⁶

33 Qq 104–110, 125

34 C&AG's Report, Summary para 15, para 2.14, and Figures 10 and 12

35 *ibid*, paras 2.18–2.20, Figures 9–10, 12; Qq 59–60, 117–119

36 C&AG's Report, para 2.17 and Figure 8; Qq 19, 80

Figure 4: Civil evasion penalties and prosecutions on VAT

Year	Number of cases where civil evasion penalties imposed	Average value of revenue evaded per case (£)	Total revenue evaded (£million)	Number of VAT fraud prosecutions
1999–00	861	37,000	32	94
2000–01	729	37,000	27	37
2001–02	346	56,000	20	89
2002–03	276	59,000	16	86

Source: C&AG's Report, Figure 8, p16 and Figure 11, p18

27. Customs may investigate any case of suspected VAT fraud with a view to bringing criminal proceedings, but usually does so only in more serious cases; for example, where the fraud involves the registration of one or more businesses whose activities are bogus or cases where professionals such as lawyers and accountants are involved. Of the 176 VAT criminal investigations completed in 2002–03, 86 were prosecuted with a revenue value of £139 million and 69 resulted in convictions. The 92 individuals involved in these cases received sentences ranging from nine months to six and a half years, the maximum sentence for VAT fraud being seven years. Fifteen of the cases prosecuted involved missing trader fraud of which seven cases led to convictions. The number of VAT fraud prosecutions completed in most years was around 90 cases (**Figure 4**) and accounted for less than 5% of the 1,845 prosecutions brought by Customs in 2002–03.³⁷

28. The average time taken to investigate and prosecute VAT fraud cases was two years and eight months and ranged from less than a year to over five years. Various factors influenced the time taken, including the complexity of the case and the volume of evidence, the need for enquiries of authorities overseas, requests for postponement by the defence and changes in defence pleas. Sometimes Customs could wait up to a year for court time and lawyers to become available, and few courts were equipped to present large volumes of evidence electronically. Customs is seeking to address these problems with the Department of Constitutional Affairs, including the possibility of making a court with full electronic equipment available to Customs full time.³⁸

29. Customs is also introducing various improvements in its investigations in response to the Butterfield report of July 2003.³⁹ This recommended that more expert legal advice was needed to improve the quality of cases and that Customs' investigations should be subject to systematic external scrutiny. It also found that while the basic training for investigators was reasonably thorough and regularly updated, subsequent training needed to be improved as it was not systematic. In other Departments there has been a move towards university accredited training to improve the standards of criminal investigations. Customs does not have accredited training for its investigators dealing with external fraud, but plans to gear future training to meet the standards set by the Police Skills and Standards Organisation, and to obtain external accreditation of training and externally recognised qualifications for these staff.⁴⁰

37 C&AG's Report, paras 2.22–2.23; Qq 15–18, 51–54

38 C&AG's Report, para 2.24; Qq 66–69

39 The report by the Hon. Mr Justice Butterfield of July 2003 was a review of the criminal investigations and prosecutions conducted by HM Customs & Excise.

40 C&AG's Report, paras 2.14, 2.28–2.29; Qq 45–49, 91–95, 126–127

Formal minutes

Monday 28 June 2004

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allan

Mr Richard Bacon

Mrs Angela Browning

Mr David Curry

Mr Ian Davidson

Mr Frank Field

Mr Brian Jenkins

Jim Sheridan

Mr Alan Williams

The Committee deliberated.

Draft Report (Tackling VAT fraud), 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 29 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report, as amended, be the Thirty-sixth 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 30 June at 3.30 pm

Witnesses

Wednesday 31 March 2004

Page

Mr Mike Eland, Mr Mike Wells, and Mr Richard Summersgill, HM Customs and Excise

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List of written evidence

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

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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>)
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Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 31 March 2004

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allan
Mrs Angela Browning
Mr Ian Davidson

Mr Frank Field
Mr Brian Jenkins
Mr Gerry Steinberg

Mr Tim Burr, Deputy Comptroller and Auditor General, National Audit Office, further examined.

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

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL: HM Customs and Excise: Tackling VAT Fraud (HC 357)

Witnesses: **Mr Mike Eland**, Acting Chairman, **Mr Mike Wells**, Director of Law Enforcement Policy, and **Mr Richard Summersgill**, Head of VAT Assurance, HM Customs and Excise, examined.

Q1 Chairman: Good afternoon and welcome to the Committee of Public Accounts where today we are considering the Comptroller and Auditor General's Report on tackling VAT fraud and we are joined by Mike Eland who is Acting Chairman of HM Customs & Excise. Mr Eland, would you introduce your colleagues, please.

Mr Eland: On my right is Mr Mike Wells who is Director of Law Enforcement Policy and Strategy and on my left is Mr Richard Summersgill who is the Head of VAT Operations in the Business Services part.

Q2 Chairman: Mr Eland, why do you lose a staggering nearly £12 billion a year in error and fraud?

Mr Eland: The reasons are numerous. This is a picture of the whole of the VAT function right down from the simplest errors that are made to some very major frauds operated by organised crime. We have taken an initiative to measure that, we have set up a strategy to tackle all components of it and we are making good progress in getting it done and under control.

Q3 Chairman: You are not complacent?

Mr Eland: We are not complacent, certainly not. It is a worrying figure, I accept, and it is something that we are determined to tackle and bring down.

Q4 Chairman: Do you have the remotest chance of meeting your target of reducing the VAT gap to 12% by 2006?

Mr Eland: Yes, we believe we have. VAT receipts this year are now running £3 billion ahead of forecast and we believe that at least £1 billion of that is attributable to the way in which we have tackled missing trader fraud, which is the most serious of the frauds.

Q5 Chairman: So, that is a firm commitment. When you come back here in 2006, we are going to see this target met.

Mr Eland: I very much hope so, yes.

Q6 Chairman: So, it is not a firm commitment?

Mr Eland: I cannot commit in that sense but it is my strong belief that that is what we will be able to achieve, yes. I have confidence in that.

Q7 Chairman: Is there a risk of an increase in missing trader fraud with the advent of new States into the EU? For the benefit of my colleagues, you might just take a minute and describe, in simple terms, carousel fraud.

Mr Eland: It basically takes place where a firm in the UK is able to obtain goods free of VAT from another country within the Community. They then sell that on to somebody within the UK and then that firm disappears. It winds up as a company without paying the VAT over to the Exchequer. Other people in the chain can claim input tax for that VAT which means that the loss is sustained by the Exchequer. That is it at its most simple.

Q8 Chairman: That is fair enough for us.

Mr Eland: Or you can do it many times round and obviously that is why it is called a carousel fraud. As to whether there is a greater risk when the Union expands, we do not see an immediate risk to ourselves from that. Clearly, there will be a risk in the countries bordering the new applicants but one of the characteristics of this fraud is that the geographical proximity is an issue in it. Obviously, if you are looking to rotate through that carousel a number of times, it helps if you have geographical proximity.

 HM Customs and Excise

Q9 Chairman: Could you explain, for instance, what links you have with the Customs & Excise for, say, Lithuania, Latvia and Estonia.

Mr Eland: We have had meetings with Poland and with Czechoslovakia, Hungary and I believe some of the other applicant countries to tell them of our experience of this fraud in order that they are prepared to tackle it and of course this is not something that is unique to the UK either. There are other existing States within the European Union who are suffering from this problem and they are engaged in those conversations too.

Q10 Chairman: How can you tolerate a situation where up to 180,000 traders are not registered for VAT?

Mr Eland: This is the number of usually fairly small businesses who are trading in the shadow economy and above the VAT registration threshold. We do not tolerate it. We do have a vigorous campaign to reduce that number and we are working with the Inland Revenue and the Department for Work and Pensions in tackling that sector of the economy.

Q11 Chairman: Why did you wait until last year before starting to match records with the Inland Revenue?

Mr Eland: The data matching exercise is something that we have not really had the ability to do under the terms of the exchange of information restrictions between ourselves and the Inland Revenue until those restrictions were modified a few years ago and I think this is one of the products of both that relaxation on information exchange and also a product of the closer working programme we had with them.

Q12 Chairman: In the situation about which we are talking, that we are losing nearly £12 billion in error and fraud, I think the members of this Committee could be forgiven for being absolutely staggered that, until last year, you were not matching records with the Inland Revenue. After all, you are the government within the law system. There are a number of government departments but it is difficult to plead the law when you are in charge of the law. It is just an extraordinary situation.

Mr Eland: I would like to make a distinction there between matching, ie the systematic comparison of records with the close working between investigators and some which is of very much longer standing than that, which we have had at the top end of the range. So, the data matching is very much focused around the VAT registration threshold where Inland Revenue, because they are collecting for very small businesses, have a business record which is not available to us because of our registration threshold relative to other countries in the EU. So, we do not have those businesses coming into our sight until they reach that level and the Revenue obviously have an earlier view of them and that is what is involved in this data matching exercise.

Q13 Chairman: Can you look, please, on page 13 at paragraphs 2.2 and 2.3. I am asking here about non-compliance. Is it right that you do not know how much of the £4 billion that may be lost is due to error and how much is due to fraud?

Mr Eland: We cannot split that out because, in order to determine that something is fraud, you have to prove it is a criminal intent. It is very difficult to do that statistically across a large block of activity. So, we have what we call a compliance continuum where you have a behaviour ranging from completely innocent error through to people who are slapdash and careless through to people who are actually positively reckless, turning blind eyes, and then through into outright criminal behaviour. So, it is that spectrum of behaviour. To try and estimate that in a statistical way is actually quite a difficult task. It is one that we accept we need to continue to work on and we will certainly be doing so.

Q14 Chairman: You obviously have different methods to deal with blunderers and cheaters. I just wonder whether your methods are the right ones. How can you possibly have an effective solution when you apparently do not understand the problem?

Mr Eland: We do understand the problem to a much greater degree than we did until the last two to three years. We have certainly been able to separate out the large-scale criminal fraud of the type that is involved in missing trader fraud. What we have more difficulty in doing is saying when there is a business which is continuing a legitimate business but maybe is suppressing part of its activity. It is quite difficult to establish when criminal behaviour occurs in that and when it is lesser behaviour than that. It is that sort of area that we are talking about.

Q15 Chairman: Would you look at figure 12 on page 19 and at the bottom left-hand corner. Do we conclude from that that you only managed to successfully prosecute 69 people last year?

Mr Eland: Yes. That is correct in terms of the number of prosecutions.

Q16 Chairman: There are 1.7 million traders; is that correct?

Mr Eland: Yes.

Q17 Chairman: I find this extraordinary. Are you telling us—do I have this right?—that 1,699,931 traders are honest?

Mr Eland: No, we are saying that we do not always take prosecution action in every case as table 10 shows and we also take civil evasion action which can lead to very significant financial penalties that fall short of a criminal prosecution.

Q18 Chairman: Somebody might say that if an organisation is losing up to £12 billion a year and it only successfully managed to prosecute 69 people, they were being either complacent or incompetent. What would your response to that be?

HM Customs and Excise

Mr Eland: I would say that is totally wrong because, as I say, you are looking to apply a range of sanctions for a range of different behaviours.¹

Q19 Chairman: Let me stop you there. Would you look at figures 8 and 11 on pages 16 and 18. If you are right in saying that you are relying on civil penalties, why have they fallen substantially in recent years?

Mr Eland: Because what we have been doing is prioritising towards the most important cases which we are prosecuting criminally. In a missing trader fraud case, the average revenue at stake is, I think, £17 million. In some of the civil cases, it is very much less than that, it is about £50,000. What we are looking to do is to prioritise between those two and also with other criminal cases in addition to the missing trader fraud, concentrate our investigation resource on the missing trader fraud in the criminal cases and reduce some of it on the civil evasion area. What we are then doing in addition to compensate for the reduction in number of the civil evasion cases is that we are following through on those in our normal assurance effort where we can also impose a penalty up to 15% of the tax. So, we are not allowing any case where we are concerned at the level of tax going missing to go untackled and we are addressing at the appropriate level of penalty action in those cases.

Q20 Mr Allan: To come back to the carousel fraud issue which is completed, on table 16 on page 26, you have set up a diagram of the different suppliers who have the stuff he moves around with other companies. What I want to know is, who are the crooks in this? Are they all crooks, people who are knowingly engaged in fraud when you have this, or is there a risk that legitimate businesses get caught up in this?

Mr Eland: It can vary; it can be both. Legitimate businesses can get caught up in some aspects of the fraud although, if it is a carousel fraud, I think one would expect them to question quite why such a volume of traffic is coming through. So, there are some grey areas in this. It varies very much according to the scale of a particular operation.

Q21 Mr Allan: But, when you are dealing with something like £1 million worth of mobile phones circulating around here, everybody in this chamber presumably knows that they are part of a fraud. This is not going to the Car Phone Warehouse and things like that.

Mr Eland: I would not go so far as to say that they know they are part of the fraud because what they are doing is receiving from a legitimate company an offer to sell some phones to them. It is only if that starts to sort of escalate that you might expect them to suspect it, but they could be used on a one off. These buffer companies can vary very much. They

are not necessarily always the same person. They are designed deliberately to conceal the movement from us.

Q22 Mr Allan: Who is making the money here?

Mr Eland: It is the organiser of the fraud. They will use straw men in some of the companies who will be paid a sum to do something.

Q23 Mr Allan: So, you do get somebody who says, “£50,000 to set a company up to take some mobile phones and sell them on, no questions asked.”

Mr Eland: That would be obviously deliberate fraudulent activity. So, in that case, that company would be caught in that. Yes, it is that sort of thing.

Q24 Mr Allan: You have said these are very large numbers but people think of VAT fraud as the archetypal dodgy small business that says, “Pay me in cash and I will give you a discount.” This is big money.

Mr Eland: The missing trader fraud is big money. There is organised crime involved. You have seen the figures and the scale of the losses.

Q25 Mr Allan: You give in case study 8 on page 28 an example of what we would like to see happen to somebody, a brother of a fraudster trying to set up a new company and you simply refused to register the company and you estimate that, by your act of refusal, you saved the taxpayer £4 million. That begs the question as to why we cannot do that in far more cases. If we look at paragraph 3.9, it tell us that, between 2002 and 2003, you received around 0.25 million applications to register, just over 1% of which were granted due to concerns about possible fraud. Do you have a working estimate for the number of those registrations that were likely to have been fraudulent?

Mr Eland: What we are doing is refusing outright quite a large number of registrations. Last year it was around 1,500 and then there is another batch about which we might not be fully convinced that the company is totally right, so we might attach some conditions to that. Now, they might look small in percentage numbers because obviously there is a very big turnover in the economy and we are talking about over 100,000 registrations coming on each year, but what we are trying to do is spot a fairly small number of people within that. This is not a fraud, as you say, where there are large numbers of companies involved.

Q26 Mr Allan: We know that over £2 billion has been taken by these people, so a number of them are succeeding in registering. I am trying to identify the gap between those—

Mr Eland: They were. As I said, we believe we have brought that down by at least £1 billion in the course of this year through the measures we have taken. So, we would say that we are beginning to knock them out of the system. I do not know if Mr Wells wishes to add anything.

¹ *Note by witness:* As confirmed in the Report, the figure of 60 refers to the number of successful VAT prosecutions undertaken. These resulted in 92 people being convicted. A further 17 cases were unsuccessfully prosecuted.

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Mr Wells: Obtaining new registration is not the only way in which the fraudsters work. Recently, we are seeing a trend of these people hijacking registrations. That is to say that the fraudster simply adopts the identity of an existing trader and hijacks their number. So, as we have been successful in restricting opportunity to register in the first place in their own guise, as it were, we have seen them hijacking others.

Q27 Mr Allan: You surely would not send a cheque to somebody who is using a fraudulent number.

Mr Wells: These individuals do not enter into the system, as it were, with us at all. They masquerade as traders. They purport to charge VAT to others who are registered and then take the money out. So, we are not sending cheques to these individuals at all, which is why they are able to purport to be VAT registered when in fact they are not.

Q28 Mr Allan: So, the money is going to the poor dupe further down the line who has sadly bought the goods.

Mr Wells: Exactly.

Q29 Mr Allan: Regarding the recommendation on page 6 at paragraph 22 about the VIES, the VAT Information Exchange System, which is going to be one of the major tools or has the potential to be one of the major tools to try and stop all this happening, can you just tell us where we are with that.

Mr Eland: It is a system that is in operation already and has been for some years. What we are looking to do is to improve it in order to enable us to get better assistance from it in identifying fraudsters. The essential point is that, when the single market was introduced, we lost the information that we were getting from import and export data on intra-community movements. In place of that, this system was introduced where companies in each Member State make returns to it and then that data is swapped between the different Member States to give them a picture of intra-community movements and trade, but that takes place only once a quarter, so we are working very much in arrears and there are defects in the data. So, what we are looking to do is to work on that to improve the quality of the data and ideally its frequency without putting any serious burden on legitimate business activity within the Community area.

Q30 Mr Allan: And you are putting dodgy British traders—?

Mr Eland: It is not dodgy, it is listing all activity that is going on between legitimate traders in order that you can then start to spot patterns. In addition to that, we clearly are exchanging information on people we regard as dodgy through separate arrangements, mutual assistance arrangements as they are called, with tax authorities in the different Member States.

Q31 Mr Steinberg: I would like to begin with a very basic general point. If you could look at figures 1 and 5 together, in figure 1 we can see clearly that the biggest source of revenue is VAT at £63.6 billion

where you have the biggest fraud of £11.9 billion.² Yet, if you look at figure 5 and paragraph 2.10, it shows that in fact the percentage of intelligence resource that is put into the system seems to be completely out of proportion. You have Class A drugs, 33% for intelligence source. I can understand that; I have no quibble with that at all. What I do have a quibble with is that you have VAT and insurance premium tax, a fraud of £64 billion, yet you have a 13% resource looking at that.³ On the other hand, you have tobacco smuggling/tobacco sales and that involves £8 billion and yet you have 28% of your resources looking into that. On the other hand, you have other tax coming in which total something like £8 billion and yet you have 13% of your resources in that. So, you actually have many more resources looking at £8 billion worth of income from tobacco, yet for £64 billion worth of income, you only have 13%. That seems totally out of proportion. Why is that?

Mr Eland: It is the nature of the intelligence task in each of the taxes. When it comes to those excise taxes to which you have referred, the problem is largely one of anti-smuggling, ie people who are looking to keep away from us, and therefore the intelligence task there is intelligence gathering and attempting to detect those people—

Q32 Mr Steinberg: With great respect, you are not answering the question, are you?

Mr Eland: I think I am.

Q33 Mr Steinberg: Why have you put so much resources into that?

Mr Eland: Because we do not need that type of intelligence resource as much in the VAT system because, as I was attempting to explain, we have a whole range of sources of information that companies have to deal with and have to come into the system in order to perpetuate the fraud. So, the problem is a totally different one. The intelligence resource is not—

Q34 Mr Steinberg: That is irrelevant.

Mr Eland: I do not think it is.

Q35 Mr Steinberg: In terms of resources, the way I interpret this, it is a case of you getting a certain amount of money or resources to put into intelligence to find out who is smuggling, who is defrauding and who is doing what, and you spend less money on trying to find out who is defrauding out of £64 billion worth of tax that is coming in than you do on £8 billion worth of tax of tobacco. You have more people looking at smuggling tobacco than you do of defrauding the VAT. It seems crazy.

Mr Eland: No, we do not. We have resource in the VAT area who are collecting the information and analysing it for risk purposes and passing it to our intelligence people and to our investigation people but who are not called intelligence staff. They are

² Note by witness: £11.9 billion represents the total VAT loss, not losses due to fraud alone.

³ Note by witness: £64 billion is the total net amount of VAT collected, not the total amount of VAT fraud.

HM Customs and Excise

doing other activities within the VAT system as well. So, to get a true comparison of that activity, you would have to include them in the equation as well.

Q36 Mr Steinberg: So, let us include those in the equation. How many or how much resource do you put into getting the fraudsters who are defrauding you or us of £12 billion compared to the amount of resources that you put into, let us say, the other taxes—I do not know what they are—of £8 billion that are getting spent by yourself? How much money is actually spent?

Mr Eland: You have the 8,000 VAT assurance and collection staff and you have the investigators and so on who are dealing with this problem. It is a very different problem that we are dealing with here or a different set of problems if you are looking at the whole of the £12 billion VAT loss and so I do not think that is—

Q37 Mr Steinberg: Explain to me, if that is the case, why are you reducing the amount because it was 16%, if I read it properly, and now it is down to 13%? So, you have actually reduced your budget by 3% when fraud is increasing by 1% a year.

Mr Eland: For that particular activity we did switch some resource there into the tobacco area which is also an extremely serious problem, but we were able to substitute by using this wider VAT resource which enables us to continue to keep a handle on the different types of fraud that are occurring in that area. Just because somebody is labelled “intelligence”, it does not mean that that is the only way we have of gathering information about these problems.

Q38 Mr Steinberg: What is the 1% difference in terms of revenue that is being defrauded, as a matter of interest?

Mr Eland: I am sorry, the 1%?

Q39 Mr Steinberg: My understanding is that the amount of VAT that has been defrauded has increased by 1% this year. How much is that equivalent of?

Mr Eland: The overall loss, it is not all down to fraud and it was last year as well. This year, we believe we have actually managed to bring it down by probably at least £1 billion and maybe more.

Mr Wells: Each 1% equates to around £1 billion.

Q40 Mr Steinberg: So, there was £1 billion more fraud and you put less resources in to try and find out who was actually defrauding.

Mr Eland: No.

Q41 Mr Steinberg: I think that is incredible. I have added up—and my maths is not very good—and my maths tells me that the revenue, or yourselves, collected something like £109 billion worth of revenue a year and I worked it out at something like £20 billion worth of fraud a year in the whole of the Customs brief; do those figures seem correct?

Mr Wells: The total losses of all type including avoidance, including error and fraud—

Q42 Mr Steinberg: I am not just talking about VAT.
Mr Wells: Across all of those would be of roughly the order that you said.

Q43 Mr Steinberg: Twenty billion pounds?

Mr Wells: Yes.

Q44 Mr Steinberg: I think that for a department that is, frankly, not collecting £20 billion, your attitude is very complacent. We would not be having this debate today if you had collected that £20 billion because the whole of the public sector would change in terms of finance. Think what you could do with £20 billion! Frankly, gentlemen, I think that really you will have to get your fingers out and tackle this and find out where some of that £20 billion is going.

Mr Eland: As I have said, we have succeeded in increasing VAT receipts this year by over £3 billion. If that is sustained over the next few years, then we will succeed in driving down and meeting our targets. I do reject the complacency charge. It is us who have tried to quantify this problem and size it. We have set up a strategy for how to deal with it and we are making good progress—as I say, £3 billion of receipts in this year—in tackling it, so I really do not accept that we are being complacent.

Q45 Mr Steinberg: That was my point of view and the Chairman seemed to have the same sort of view and we had not collaborated before this meeting. Is it correct that you have, according to this Report, about 1,800 investigators?

Mr Eland: Yes.

Q46 Mr Steinberg: To cover the whole of your remit?

Mr Eland: Yes.

Q47 Mr Steinberg: I worked out from the figures that have been given to me that there are 18 investigators looking into £12 billion worth of fraud.

Mr Eland: I am sorry, that is wrong. The £12 billion figure is all losses including the businessman making a mistake, people filling in—

Q48 Mr Steinberg: The businessman making a mistake! With respect, Mr Eland, the businessman making a mistake is still a loss of revenue to the Customs & Excise.

Mr Eland: It is.

Q49 Mr Steinberg: And to you and I.

Mr Eland: But that does not then lead to a criminal investigation—

Q50 Mr Steinberg: I never mentioned a criminal investigation.

Mr Eland:—by those 1,800 people. What it does lead to is action by the 8,000 people we have working on VAT assurance activity. So, you have to take the whole resource if you are looking at the whole of the problem, not just the criminal investigation resource.

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Q51 Mr Steinberg: We have established that we have 18 investigators looking into £11.9 billion worth of fraud and you are not worried about that.⁴ Well, that is fair enough. People can make their own minds up on that! I am always confused, I must admit, but I am even more confused because, when I read the supplementary answer⁵ that you sent to the Committee probably this or last week when we asked about the number of prosecutions that had been taking place over the last five years, the information you gave us was that, in 2002–03, there was 1,845 cases and you had 1,625 convictions. Presumably, that means in the whole of your remit.

Mr Eland: Yes, it does.

Mr Steinberg: Yes, the Report tells us that there were 86 cases on VAT; is that right?

Chairman: I think you want to go to figure 12, page 19, which is what I referred to.

Q52 Mr Steinberg: I added up 69 and 17, so my maths is not too bad after all! In fact, out of those 1,845 prosecutions, only 86 were on VAT fraud.

Mr Eland: Yes, that is right.

Mr Steinberg: And you say you are not complacent! I can tell you 86 people who are defrauding VAT now! I can give you their names!

Q53 Chairman: Right, go ahead!

Mr Eland: As I said to the Chairman, what we are looking to do in the prosecutions area is to concentrate the resource on the most difficult types of criminal fraud and to use other sanctions to tackle other behaviour. So, again, you will have to look at that whole picture.

Q54 Mr Steinberg: Mr Eland, the point I am making is that there is a huge VAT fraud going on in this country and there are very few prosecutions being taken to try and recover that £12 billion and you have, in my view, a very small proportion of the resources available to actually investigate that and yet you say there is no complacency. I am sorry, I just cannot accept that.

Mr Eland: I have tried to explain the reasons why I do not totally accept the comparisons you are making.

Mr Steinberg: You have, I appreciate that.

Q55 Mrs Browning: On page 33, we see that, following your one-off amnesty in 2003 when you encouraged people who were not registered to register and you brought in 26 million as a result of that, thereafter you decided to get tough.

Mr Eland: Yes.

Q56 Mrs Browning: Can you tell me how you got tough and what the results of getting tough have been.

Mr Eland: We are following through on that having given that sort of warning period, if you like, with intensifying our effort in looking to identify people

working in the shadow economy and, in the four months between the end of that incentive period, 1 October to 31 January, we got about 1,700 registrations in which compares very favourably with the previous period. It is around an 87% increase and a 98% increase in arrears, so we do feel that we are making some progress in that area.

Q57 Mrs Browning: How much of that has been Customs & Excise initiative alone or in collaboration, say, with the Revenue? For example, if the Revenue opened up a full inquiry on business, are you automatically keyed in to that situation at the time they decide to hold an inquiry?

Mr Eland: Those figures which I have just given you are specifically for Customs activity. In addition to that, we have our joint shadow economy teams with the Revenue and with the Department for Work and Pensions. I do not know whether every inquiry is triggered to us but certainly if they feel that there may be a VAT dimension, we would expect to get involved in any of those joint team activities.

Q58 Mrs Browning: We read that you have focused—and I am sure this is right—on the criminal activities rather than those activities which would incur civil penalties.

Mr Eland: Yes.

Q59 Mrs Browning: But your problem seems to be in the area of civil cases where there is such a volume that it is hard almost to catch up or to do things that act as a disincentive other than the type of scheme that you have just exercised in 2003. If I look on page 17 and I see the civil evasion case there that is outlined in paragraph 2.19, it shows a very small business situation back in October 2001, an investigation where the value of the revenue evaded was just £32,000 of which the civil penalty was £6,000 using a formula of some 20% of the total evaded as a penalty. It does seem to me that if it is only going to be 20%, that is not much of an incentive to deal with this huge volume of cases where a lot of your problem seems to come from and I am interested to know why you set it at 20%. If you look at that type of example, a business of that size, is it because, if the penalty were higher, the person then might go out of business and you might not get anything or do you realistically think that 20% civil penalty is just and is likely to discourage others? I personally would find it difficult to think that 20% would actually discourage others.

Mr Eland: They have to also pay all the arrears of tax with the 20% on top of that and I think that can be quite a powerful disincentive. We have seen by and large with the working of some of the other automatic-type penalties we have in other parts of the system quite a significant improvement in compliance since they came in. What it will not capture is the sort of determined fraudster or determined minor fraudster if you want to put it like that, and we would not necessarily do that 20% mitigation if it were a second offence. We might consider heavier action in those cases.

⁴ *Note by witness:* There are considerably more than 18 investigators looking into VAT fraud in addition to the 8000 staff undertaking VAT assurance activities.

⁵ Ev 14

 HM Customs and Excise

Mr Wells: This is an example of the new approach where, in cases where the trader is actually cooperating with the department—

Q60 Mrs Browning: Having been caught.

Mr Wells: Or having come forward in some circumstances as well. So, this is mitigating down the higher penalties that we apply in cases where traders are not as cooperative and in fact, in these cases, we are getting in around 75% of the tax within three months rather than about one third under the arrangement that would have applied otherwise. So, we are actually getting in money considerably faster through this arrangement and clearly getting in the money at the end of the day is the biggest incentive of all.

Q61 Mrs Browning: Of these mainly small businesses, we read that a third under declare. How persistent is that and what plans do you have to tackle that?

Mr Eland: If they do under declare, they are liable without going through this civil evasion penalty approach to a misdeclaration penalty which is usually 15%. So, if we felt that it was justified, we would apply that sort of penalty each time. If we felt there was repeat behaviour, we might move up a notch and, as I say, ultimately we could move into prosecution. Also, it would change their risk categorisation, so we would be visiting them more frequently to make sure that that behaviour was not repeated. So, if you like, their credit rating with us would deteriorate and that would mean that we would pay much closer attention to the business.

Q62 Mrs Browning: Do you categorise the businesses as I believe the Inland Revenue do in terms of sector, particularly focusing on those sectors which deal with cash a lot?

Mr Eland: Yes. We do a central risk assessment of every individual company according to their history and, on top of that, we also do a sector examination and we are increasingly moving down that approach which we have found very beneficial and clearly there are some higher risk sectors than others. We have special cash teams that work in the areas that deal in cash trading.

Q63 Mrs Browning: What analysis have you made of the scope of fraud and under declaration and all the things that are identified in this Report by companies and individuals who focus mainly on Internet trading? Is that something that is likely to compound these problems? Is that something which is compounding these problems?

Mr Summersgill: We have done some research into the risk presented by the Internet and the different types of fraud, in particular, for example, with gambling, the risk of evasion or avoidance. In terms of VAT, we have also put in place systems to make sure that we can capture the VAT in respect of supplies over the Internet from third countries. So, it is something at which we have been looking but we

probably do need to do a little more work in terms of looking at how the Internet might increase revenue risk in specific trade sectors.

Q64 Mrs Browning: Have you undertaken an analysis in terms of what this might mean in terms of fraud or lack of revenue coming in which should be coming in? Do you have any idea as to what the size of the problem is?

Mr Summersgill: We have some idea; we had to do some work on this. We think really the risk is in term of third country supplies of goods over the Internet and we have put in place a mechanism to capture that where traders in third countries are prepared to sign up to the system.

Q65 Mrs Browning: Is there any strategy in place or being worked up to deal with this?

Mr Summersgill: As I say, it is something at which we are looking. We do not consider it a great threat from the analysis we have but we are not complacent about it.

Q66 Mrs Browning: We notice at paragraph 24 on page 7 that when you do bring these large criminal cases to court, you have to wait sometimes up to a year for court time and for lawyers to become available to try the cases.

Mr Eland: Yes.

Q67 Mrs Browning: What representations have you made to try and improve that situation?

Mr Eland: We are talking to the Department of Constitutional Affairs. The problem is partly the complexity of some of these cases, which is why there are relatively small numbers of them, and we are looking to see whether we could actually have a dedicated court that has full electronic equipment in order that we can present thousands of documents electronically which would clearly help quite a lot.

Q68 Chairman: You are dropping your voice.

Mr Eland: I apologise. I was saying that we are talking to the Department of Constitutional Affairs in order to see if we can get a dedicated court with electronic document handling equipment which would very much help in this field, but there are also some constrictions on counsel. These are very complex cases and you need to have the people who have the skills to prosecute fraud. So, that does also lead to some restriction but they are both areas we are looking to address.

Q69 Mrs Browning: Are you getting a favourable reception from the department?

Mr Eland: Yes, we are.

Q70 Mr Jenkins: You said in answer to the Chairman, "We are committed and we are going to close this VAT gap."

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Mr Eland: Yes.

Q71 Mr Jenkins: It is easy, is it not, since the VAT gap is what is actually collected by you and an estimate of what should be collected by you. So, all you have to do is reduce the estimate and you have closed the gap!

Mr Eland: I am sure that if I came to this Committee and used that as an argument, I would very rapidly be subject to difficult questioning. We are clearly looking to improve the yield and I imagine in future that is what you will be looking at.

Q72 Mr Jenkins: In the Report, figure 2 on pages 11 shows that you use the top down approach whereas the bottom up approach would show that your gap is very, very quickly closing. What is the difference between the two in essence?

Mr Eland: The top down is done by our analysts or economists and is essentially a statistical exercise. The bottom up approach is something we try to do using information coming through our operational teams and to build up a picture of how we see the fraud. So, that is what we are trying to do.

Q73 Mr Jenkins: So, by merging the two and coming to a compromise figure, you actually close the gap, do you not?

Mr Eland: We are not presenting it in that way. The figures by which the targets—

Q74 Mr Jenkins: But it is possible.

Mr Eland: I am sure it would be possible if that were the way in which we wanted to present it but we are not presenting it in that way.

Q75 Mr Jenkins: In answer to another question, you said that VAT had increased by £3 billion.

Mr Eland: Yes.

Q76 Mr Jenkins: Did that VAT increase because of your efforts to collect the tax in or did that VAT increase because the economy was doing so well? When I go to my petrol station, I pay VAT. There are loads more traffic and loads more people on the roads, so we are collecting much more VAT in, are we not? So, which is it?

Mr Eland: It is not the economic effects. If consumption has increased, that is taken out of the equation. So, it is largely, we think, as a result of our efforts. There will be an element. We have not fully analysed that £3 billion and we will not be able to tell until later in the year as to what its different components are but we are fairly confident, as I was saying, that at least £1 billion of that is because we have reduced the amount of fraud. So, it is not an estimate issue.

Q77 Mr Jenkins: When you said in answer to Mr Steinberg's question that you have transferred resources to serious crime, you must have done a value for money approach on this.

Mr Eland: Yes.

Q78 Mr Jenkins: You must have looked at the amount of cost involved in the searching, investigating and the bringing to court of these cases against what would be brought in—I would not say it is either/or but, if you are switching resources, you have made that decision—by visiting small traders and capturing small traders and rolling them out, which I presume would be quite a quick exercise.

Mr Eland: Yes.

Q79 Mr Jenkins: There are two cases on pages 32 and 33 and the one on page 33 is where you visit the small trader, decide that he is not paying the requisite amount of tax in case 10 and you collect £73,000 in tax. How many cases of £73,000 would you undertake and wrap up and collect on at a time of involvement it would take in the serious crime squad?

Mr Eland: The average amount involved in a serious investigation is about £17 million. In a big criminal investigation, it is about £1 million. In some of these smaller cases, it is below £100,000. So, those are the sort of ranges about which we are talking.

Q80 Mr Jenkins: If you could do one of these a week, roughly a two year case, I am talking about £7 million. You could collect in £7 million off small traders whereas, when you take your large case to court and we know that there is an estimate that maybe they defrauded VAT of £30 million, you bring back moneys and some of your cases show that you bring back in very small amounts because the individual does not have the assets anymore.

Mr Eland: We are seeking to tackle all of those levels. As I said, we would not use a trained criminal investigator to look at some of these cases. We would use a VAT assurance officer and VAT assurance officers are bringing in about £3 billion a year there.

Q81 Mr Jenkins: Do you think it is justifiable that you have actually done a value for money exercise by ensuring that you are going to get more money out of the serious crime activities by diverting resources away from this type of activity, the small trader?

Mr Eland: We have to cover all of those different elements. We are obviously trying to optimise the use of resource across those areas and we do look at things like the rate of return that we are getting.

Q82 Mr Jenkins: So, the answer is “yes”?

Mr Eland: We do use cost benefit analysis in how we allocate our resource.

Mr Summersgill: These two cases are specifically done by our shadow economy teams which are looking for those 125,000 to 180,000 people who are trading above the threshold but are not registered. We have about 200 staff years going into that sort of activity which is routinely capturing about 4% or 5% of those people. One can argue either way how much resource you should put into that but I think that is about the right balance.

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Q83 Mr Jenkins: All I wanted to know was that you had done the evaluation, you had done the analysis and you decided it was best and good value for money to put the resources out of what is an easy roll-out plan

Mr Eland: Yes.

Q84 Mr Jenkins: I have a belief that you would be far, far better off if you were paid by the results. I think if you were just told to go out there and collect it in you would collect it in and I think this would drop dramatically. That is what Mr Steinberg was referring to in the allocation of resources point, where you felt the allocation of resources was disproportionate to the cost overall and now you have assured me you are doing the figures.

Mr Eland: Yes, we are.

Q85 Mr Jenkins: You got an extra 1,000 staff over the last three years.

Mr Eland: Yes, that is right.

Q86 Mr Jenkins: What return do you expect from the extra 1,000 staff?

Mr Eland: The target which has been set is two billion.

Q87 Mr Jenkins: Two billion? Will they achieve it?

Mr Eland: We hope so, yes.

Q88 Mr Jenkins: Are they on a bonus scheme?

Mr Eland: Not related to that amount of money.

Q89 Mr Jenkins: Should they be? Should they have an incentive?

Mr Eland: We do not have direct linkages to the amount of money brought in but we are clearly evaluating the performance of our staff in meeting these overall targets. If they do perform well than there are rewards within our pay system, yes.

Q90 Mr Jenkins: When they brought 69 cases successfully to court do you think they would get a bonus on that?

Mr Eland: I think you have to look at the quality of the cases as well as the quantity, some of them are extremely complex. As you will see from the case studies for some of them the trial takes six months, this is not just small-fry cases here, we are trying to tackle it is some of the higher end of the fraud market.

Q91 Mr Jenkins: We know there are very complicated and difficult cases, do you feel you have the right team in place? Do you think you have the right skills in place so that we know as we are going on that each step is being investigated so that the lawyers can tell you, "yes, we have a chance of being successful in this prosecution, this is what we need before we get the case in to court?"

Mr Eland: Yes, we do have some very skilled investigators working in this area.

Q92 Mr Jenkins: I understand there is a point in the Report which says you do lack lawyers in the team.

Mr Eland: Is this the reference in the Butterfield Inquiry?

Q93 Mr Jenkins: Yes.

Mr Eland: We have a prosecuting group of lawyers who advise during the case and are responsible for taking it to court but we should add to that and expand the number of lawyers who are actually working as part of the investigation team. We have accepted their recommendation and we are implementing it, so we are putting it in place.

Q94 Mr Jenkins: The skill level of the team is critical, is it not?

Mr Eland: Yes.

Q95 Mr Jenkins: These teams are specialist teams?

Mr Eland: They are specialist teams and as you will also see from the Butterfield Report we have accepted the recommendation there that although he was satisfied with our initial training of investigators he felt there needed to be additional refresher training, and we are also introducing that as well.

Q96 Mr Jenkins: When a case comes to court the word goes out, when you catch a small trader the word goes out and it reduces the amount of fraud in the system and traders are going to come on board. When you have caught somebody how much publicity do you give it in the local press?

Mr Eland: We are increasingly seeking to use this as a means of deterring people and to get as much publicity as we can when we do that. Part of this recent exercise we have been doing in terms of focusing on the shadow economy is we are concentrating that regionally as well as by trader type so that we can actually increase the impact it has through the local press in that region.

Q97 Mr Jenkins: Now you are going to be working even closer to the Inland Revenue so you can attack these people as a team, a concerted effort goes into it, are you going to start flagging up, are you are going to go in there and target them and hopefully bring people on board before they come under your microscope?

Mr Eland: Yes, we do want to do that sort of thing. We accept that we can do more in the press and publicity area. We do also need the co-operation of the press but certainly the local press are usually willing to do that.

Q98 Mr Jenkins: What incentives are you offering traders to come on board?

Mr Eland: We had an incentive scheme where we said to them that if they came forward in a particular period although we would expect them to pay back tax we would wave the penalties that we would apply and that would then be followed by a period of cracking down.

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Q99 Mr Jenkins: Using the carrot and stick approach, if you felt as a trader you were defrauding the VAT of £100,000 and if you got caught all you have to do is pay £100,000 plus a fine of £25,000 do you think it is worth the gamble?

Mr Eland: No, I do not think it would be quite as straightforward as that. First of all it would be a question of if we are talking about £100,000 whether we would impose the 20% or a higher figure—we have dealt with that, I think. Secondly, you are then getting that on your VAT record now and that will mean we will be paying much closer attention to you in the future.

Mr Jenkins: Would it be worth the gamble? There are thousands and thousands of people in this country driving round without car tax because they know it is worth the gamble, without insurance because they know it is worth the gamble, and I suggest they do not pay VAT because they know it is worth the gamble.

Q100 Mr Davidson: Could I just ask, first of all, whether or not there is any evidence that the level of tax of VAT affects the level of fraud? If VAT was increased by 3% is there any evidence that would affect fraud?

Mr Eland: I think the VAT rate has been stable for quite a time, so we do not have any recent evidence of that. Certainly my recollection is that when it did go up, back in the late 70s early 80s that did lead to an increase in more avoidance after that because it is obviously more lucrative at a higher rate.

Q101 Mr Davidson: In terms of international comparisons is there much more fraud in countries where it is 20%?

Mr Eland: It depends on the nature of the society and the economy as well as just the rate of VAT I think. In the high rate tax areas of the Scandinavian countries they by and large do not have quite the scale of fraud that we have but they do have some serious frauds and they are worried about the missing trader fraud.

Q102 Mr Davidson: Can I turn to the paragraph 2.2 where there is mention made there of one in three businesses underpaying or making mistakes. When mistakes are discovered can you tell me what percentage of mistakes are mistakes where the trader has paid too much in VAT? If these are things like arithmetical errors would you expect them to be evenly balanced?

Mr Summersgill: The exercise which is described in 2.2 is our compliance testing which shows about 31% errors. I believe it does break down to 28% under declare and 3% over declare.

Q103 Mr Davidson: That is what I thought. Can you just clarify for me what the value is for refunds that you have given in these circumstances? If you discover an error has been made in your favour rather than in the company's do you give the money back?

Mr Eland: If our visit establishes that they have overpaid we would pay it back, yes.

Q104 Mr Davidson: Can you give me any indication of the scale of over-payment?

Mr Summersgill: I do not have that figure, I can send you a note on it.⁶

Q105 Mr Davidson: That would be helpful to set things in context. For the large business group presumably they have accountants and professionals doing all this and they are still making errors at this sort of level. It seems to me these are not errors but this is fraud, deliberate fraud done by accountants and the like, can you clarify for me why in those circumstances there are no prosecutions of professionals?

Mr Eland: If we felt we had evidence of criminal intent and we could prove beyond all reasonable doubt then we would prosecute no matter what the size of the company, but you do have to have the evidence to do so. It is perfectly possible in the complexity of a large business to genuinely make an error but it then does obviously have quite a large consequence.

Q106 Mr Davidson: If these errors are overwhelmingly on one side rather than the other they do raise questions about the professional competence of accountants and others who are doing the books, have there been any examples of action being taken by professional associations of such accountants?

Mr Eland: I do not have any examples of that. We certainly do talk to the associations about the extent to which their own self-policing activity could help us if we felt some accountants were being particularly slapdash.

Q107 Mr Davidson: Let me be clear, somebody is presumably getting paid a substantial sum of money in a large company and they make consistent errors, all of which favour the company, over VAT payment and you say you do not report that person to the professional association and no action is taken at all.

Mr Eland: If we felt there was a clear case that there was somebody who was either incompetent or who we felt was complicit in some cheating of the Revenue then of course we would be prepared to report that person. I do not think it is quite like that in this area we are talking about, the large business area.

Q108 Mr Davidson: Presumably large businesses are entitled to receive a first-class service from professional employees or the agencies they employ to do their audit and if they are consistently making mistakes which favour the company rather than tax, either it is fraud or an issue of professional competence. I am seeking to clarify whether or not there is a mechanism by which you draw this to the attention of the professional association. If you discover arithmetical or other errors what action do you take in relation to the professional association?

⁶ Ev 15

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Mr Eland: What we would do when we found these errors is take action within the company. Whether the company have used an outside accountant or their own in-house team in constructing the VAT accounts I do not know, that would obviously vary. They will have some external auditors but they would not necessarily be looking at the VAT position and checking whether the tax law had been exactly complied with, they would be carrying out an audit of the whole company's accounts. If we felt unhappy about the quality of the finance division of a large company then we would certainly take that up and we would take it up at board level, if need be, and say that we really did think that they needed to take internal action on it.

Q109 Mr Davidson: How many times have you done it?

Mr Eland: I know of one case in the last six months.

Q110 Mr Davidson: One case. It is said in the Report that one in three businesses underpay. I understand the difficulty about prosecution but you are saying that there is only one case where you have sought to pursue the question of the professional competence of the people doing the sums?

Mr Eland: In one case in the large business area known personally to me. I do not have figures in relation to the activity throughout the whole of that operation.

Mr Summersgill: In terms of the one in three figure that comes from our compliance testing programme which tests about 4,000 businesses, which is a statistical sample, the majority of those businesses will be sole proprietors and various small businesses. It is likely that errors have been made by the person themselves or by their bookkeeper. We will often be looking at those records, certainly in the case of the larger businesses, before they have been audited even.

Q111 Mr Davidson: What is the figure for the large business group if it is not one in three? What is the figure?

Mr Summersgill: I do not think we have that with us.

Q112 Mr Davidson: Is it higher rather than lower?

Mr Eland: I think there were one billion pounds of under declarations found in the large business area.

Q113 Mr Davidson: There seems to be a huge amount of money sloshing about.

Mr Eland: Our large business group covers the top 1,000 businesses.

Q114 Mr Davidson: Right. Okay. Can I just ask about spend to save, I am struck by paragraph 2.6 "a good return of £18.90 for every £1 spent". What approaches have you made to the Government on the basis of spend to save and how were these proceeded with?

Mr Eland: The original VAT strategy consisted of about 1,000 additional staff for an additional two billion and the Chancellor announced in the Pre Budget Report a further spend to save initiative

Mr Summersgill: In the Pre Budget Report we were awarded effectively another 450 posts to put in to further effort to tackle the gap. We are putting about 150 of those into various kinds of debt management and the remainder into tackling high risk areas within that general non-compliance gap.

Q115 Mr Davidson: Can I clarify whether or not the additional money has returned resources along the lines of £18.90 per £1 spent or has it been greater or less than that or is too early to say?

Mr Summersgill: I think it is too early to say.

Q116 Mr Davidson: I will not do that again.

Mr Eland: It is a very significant rate of return we are looking for in this area. We do feel we can provide good value for money.

Q117 Mr Davidson: Can I just come back to the point some of my colleagues touched on and that is the question of penalties, the penalty of 20%, or so, does seem to me to be incredibly worth the risk, there is a gamble but if you do not get caught you get away with it and if you get caught it is only 15% on top of it. I am not clear how the 15% to 20% was decided, is that an internal decision by you or is it in legislation?

Mr Wells: This is a series of graduated penalties before we get to the criminal route which range from a maximum of 100% penalty down to 15% in a mis-declaration situation. The mitigation is down to 20% from a potential maximum of 100% in cases where there is full co-operation, a potential incentive is used in certain cases. There is a potential penalty of 100%.

Q118 Mr Davidson: How do you decide the bonus for co-operation? The penalty was brought down to 15%, why did you reach the 15%?

Mr Eland: The 15% is a separate thing. The 20% is the mitigation of the 100%. The 15% is in statute or in secondary legislation. That was part of the penalty regime which was brought in following the Keith Report. That is applied more widely than just the civil evasion cases.

Q119 Mr Davidson: Why did you decide on 20% rather than 25%, 15% or any other figure?

Mr Wells: We did a variety of research in this area, we worked with the Inland Revenue with their Hansard Process, which is a similar sort of approach which provides incentive and greater cooperation, we tested this and we believed it would get more money in quicker, with fewer appeals, and indeed that is what has happened. With these cases what we are finding is we are getting in 75% of the revenue.

Q120 Mr Davidson: The pilots demonstrated that 20% was better than 10% or 30%?

Mr Wells: 20% is the lowest we can go down to with civil evasion cases.

Q121 Mr Davidson: That seems to be the most effective in term of these pilots?

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Mr Wells: In those cases where there is full co-operation. Clearly in cases where there is less than that then we may not reduce it to that figure, it is an incentive.

Q122 Mr Davidson: The point about pilots is an interesting one, to what extent do you pilot different approaches to tackle particular issues in particular sectors?

Mr Eland: We do pilot different forms of risk testing in different areas. For example we have done one with the Inland Revenue where we have taken some big construction projects and worked through all of the oversight companies through to the sub-contractors. We experiment in that way doing different approaches to risk.

Q123 Mr Davidson: How many different sorts of pilots do you have running throughout the United Kingdom?

Mr Summersgill: Quite a large number, I cannot tell you off the top of my head.

Q124 Mr Davidson: Is 1,000 a large number?

Mr Summersgill: We are probably talking about 30 or 40 different pilots to try different approaches. We do things called test drilling, which are basically small pilots looking to test the size of different kinds of risk. We are also doing pilot projects testing different kinds of approach. For example, in London recently we ran a short pilot where we invited solicitors effectively to do a self-audit, and that was quite successful. That started in London in the last financial year 2003–04.

Q125 Mr Davidson: I want to clarify the pattern of a trial, it is just in relation to prosecution and the decision to prosecute in 2.15. If you decide to prosecute this will depend on whether lawyers, accountants and others who advise on VAT matters are involved. In how many cases was action then taken against the advisers?

Mr Eland: I do not have that information. Clearly if we felt they were part of the conspiracy we would take action. I do not have a number for that.

Mr Davidson: Having been involved in the work on the Proceeds of Crime Bill it is clear that the advisers in many cases are the people who make all this happen and they are the ones that generally walk away scot-free and no action is taken against them. It relates to the point I was pursuing earlier on about the professional competence of advisers, it seems to me in all of this advisers are being dealt with very, very leniently.

Chairman: Do us a note if you have information on that.⁷

Q126 Mr Field: In answer to Mr Steinberg you were talking about your officers specialising in countering fraud, do you know how many have the accreditation, the government approved professional qualification?

Mr Eland: The Government approved accreditation is very much directed at internal fraud and all our internal investigators are qualified in that way. Following the Butterfield Report we are looking to accredit all of our training of investigators to an external body and we are going to follow the police service standards.⁸

Q127 Mr Field: Various government departments are backing the professional qualifications for countering fraud officers not just dealing with internal matters, the Department of Health is dealing with contractors, might you look at that?

Mr Eland: I will look at that.⁹

Q128 Mr Field: Following Mr Davidson's point, he raised the question about how many accountants and other professionals were referred to their professional associations, you were unclear about that, could we have that covered by a note as well?

Mr Eland: I will have a look at that as well.¹⁰

Q129 Mr Field: Could you tell us something about how you as a Department try to learn from your successes against countering fraud?

Mr Eland: We do use methodology, part of our intelligence operation is very much identifying criminal methodology and patterns from existing cases and investigations and then turning that into information that is disseminated to investigators and other so that they can spot future things of that type.

Q130 Mr Field: To what extent do you share and learn from other departments? Do you regularly meet other departments and share information about countering fraud?

Mr Eland: The Department for Work and Pensions, the Inland Revenue and ourselves in particular do that.

Q131 Chairman: Could you say something about what "do" means, please?

Mr Eland: In the case of those three departments in the shadow economy area we are working in joint teams. We have constant information sharing round that. With the heavier sort of frauds we have contacts between our investigation service and the Serious Compliance Office in the Revenue.

Q132 Mr Field: My last point is a question which was raised by Mr Steinberg or Mr Jenkins about bonuses.

Mr Eland: Yes.

Q133 Mr Field: When we had the Lord Chancellor's Department here examining their lamentable record in collecting fines they promised us they were going to consider an idea of paying bonuses and learning from those officers who collect the most, it was not put to you as a joke question but as very serious one, I wonder to what extent you have considered or

⁸ Ev 16

⁹ Ev 16

¹⁰ Ev 16–17

⁷ Ev 15

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whether it is one of the pilot studies Mr Davidson was referring to or might be one of your pilot studies?

Mr Eland: Two comments on that. I am sorry I did not mean to treat it as a frivolous point, I do accept it as a serious point. What we do is try to reflect an individual's performance over the whole year in a performance pay system. If they are very successful in pursuing fraud that will be reflected and that will translate into a bonus. We have not tried to link the amount of that bonus to amounts of fraud detected. Another possibility which we can look at is under the question of whether we have team bonuses, because that can also be helpful in this area. We have done some experimentation.

Q134 Mr Field: What is it linked to?

Mr Eland: They will be given a performance report. They will be given targets that they ought to achieve during the year and then they will be given an overall box marking in relation to their performance against those targets. That box marking will earn them a bonus, it is indirectly linked, not directly linked.

Q135 Mr Field: Given that these officers will be lamentably paid compared with the professionals they come up against have you got some idea of the differences in salaries and to what extent bonuses might close that gap?

Mr Eland: Clearly there will be significant differences in salaries in different parts of the economy. We are dealing with everybody from small businesses through to large businesses, so it will be variable. Clearly for somebody in our large business office who is dealing with a large company the difference could be significant.

Q136 Mr Field: The better your officers are the more likely it is that they will be poached.

Mr Eland: There has been movement between us and the private sector. It has not always been one-way. Particularly in the avoidance area, we have set out to recruit people from the top end of the accountancy profession to come and work and help us detect avoidance schemes and the like. The head of our tax practice at the moment is an ex-partner in one of the big four accountancy firms.

Q137 Mr Field: As we are trying to draw general lessons from our inquiries in our report, might we have a note from you on not just how your bonus system works, if there are more details you want to give us, but whether on reflection you think that it could be developed?

Mr Eland: Yes, we will be pleased to do that.¹¹

Q138 Chairman: Do you have any idea, and if not you can provide us a note, how much you paid out in legal fees to independent barristers and solicitors for the 69 prosecutions that you secured last year?

Mr Eland: I do not have that number, no. I will let you have a note.¹²

Q139 Chairman: I suspect that the people you were paying were charging a lot of money.

Mr Eland: Yes, they do.

Q140 Mr Steinberg: Rightly so, I am all in favour of barristers getting well paid. I always like to have a little local issue that I raise. It seems to me this afternoon, listening to what you have been talking about, that thousands of crooks seem to be getting away with murder and yet I have an issue in my constituency where an innocent businessman has been hounded by Customs and Excise through no fault of his own. I will tell you a little background and then perhaps you would like to comment because I know normally you say, "Well, we cannot comment on individual cases", but perhaps you might on this one. It is a second hand car sales business called Snippersgate '88 Limited and they had written confirmation from Customs and Excise that if they imported second hand cars from an EU state they would not have to pay VAT but they would have to pay the VAT from the state that they were actually importing from. He imported from Southern Ireland and paid 21% VAT to the two companies that he was buying the cars from. When he then presented it in the UK he was told contradictory advice from Customs and Excise, that he owed the VAT in this country. So he paid 21% VAT in Ireland and now he is getting a bill for 17.5% in this country. He objected most vociferously, as you would expect him to do, and eventually, after about two years, the Irish Government said "Yes, we will pay back the VAT, but we will only pay it back through the suppliers" and one of the suppliers has gone bust. We are talking about tens of thousands of pounds here that he has paid and yet Customs and Excise are still chasing him for the VAT in this country. That does not seem very fair to me at all. What I have tried to do is to get yourselves and the Irish Inland Revenue or Customs and Excise, whatever you call them, to co-operate and you will not. That does not seem to be very fair to me. Thousands of crooks are getting away with murder in this country, not paying VAT, and here is a man who has been given advice by the Customs and Excise who is having to pay twice.

Mr Eland: I will not fob you off by saying that I cannot comment on an individual case, I will say that I will take it away and look at it and write to you saying what we can do. I will review that case for you.

Mr Steinberg: These are very useful meetings. Very useful, I can assure you.

Q141 Mrs Browning: Just very briefly, because while Mr Steinberg was speaking I noticed here on page 24 it says: "In the Republic of Ireland, the introduction of a Criminal Asset Recovery Bureau led to a number of criminals leaving the country and others adjusting their lifestyle. Some crime groups also continued to direct operations in the Republic from overseas." In those circumstances, is that information shared by the Republic of Ireland with you? In other words, if by going overseas they have come over here, are you on to them?

¹¹ Ev 17-18

¹² Ev 18

HM Customs and Excise

Mr Eland: I should certainly hope they would share that information with us. We do have good relationships with them. Of course, we have now introduced a Criminal Assets Bureau too so maybe they have gone on to somewhere else.

Q142 Mr Field: You said you “hoped” they would, but have they?

Mr Eland: I do not know personally whether they have or not. We do have good exchanges of information with the Republic of Ireland tax authorities. We both would look to assist each other in those circumstances.

Chairman: Mr Eland, that concludes our inquiries. May I thank you and your colleagues for appearing before us. Clearly when we are talking about £12 billion of public money I think it is probably the general view of this Committee that the civil penalties are too low, the number of investigators too few and your organisation should do better. Thank you very much indeed.

Letter to the Committee from HM Customs and Excise

In preparing briefing material for this hearing, we have been re-checking the figures in the NAO report. This has highlighted an error in Case Study 2 on page 20, which states that after the trial the judge issued confiscation orders of £50 million. This should, in fact, have said £500,000.

While this doesn’t detract from the thrust of the case study, which is concerned with the complexities involved in investigating and prosecuting cases, I wanted to make you aware of the correct figure. I have copied this note to the office of the Comptroller and Auditor General as well as the Treasury Officer of Accounts.

30 March 2004

**Supplementary memorandum submitted by HM Customs and Excise for evidence session held on
26 January on HM Customs and Excise: Standard Report 2002–03**

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 ¹	97	5.04	86	4.37	119	5.39	88	4.04	91	4.93
Other ²	58	3.01	35	1.78	79	3.58	31	1.42	14	0.76

1. 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
- Cases where the defendant has been discharged after evidence has been heard.

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

11 March 2004

Further supplementary memorandum submitted by HM Customs and Excise

Question 104 (Mr Davidson): Can you give me any indication of the scale of over-payment?

The Report refers to research Customs has undertaken as part of the Compliance Testing Programme. The programme is designed to provide year-on-year comparisons of certain compliance factors and also produce a trend analysis of results that will inform the risk process. It showed that about one third (31%) of the 1.7 million VAT-registered traders may be misdeclaring their VAT liability. Of these, around 28% of errors relate to underdeclarations and 3% are overdeclarations.

Across the scope of the VAT business, declaration errors are brought to Customs' attention in two ways; firstly as a result of our own intervention resulting in an assessment and secondly as a result of a voluntary disclosure by the registered business. During the last three years the value of overpayments and underpayments in those categories can be broken down as follows:

<i>Overpayments</i>	<i>2001-02</i>	<i>2002-03</i>	<i>2003-04</i>
Total value of overpayments (inc Officer assessments and voluntary disclosures)	£1.1bn	£1.2bn	£1.1bn
Total value of Officers' assessments (overdeclarations)	£0.15bn (value) 18,114 (no)	£0.2bn (value) 14,520 (no)	£0.1bn (value) 11,469 (no)
Total value of voluntary disclosures (overdeclarations)	£0.95bn (value) 17,162 (no)	£1.0bn (value) 21,662 (no)	£1.0bn (value) 20,430 (no)

<i>Underpayments</i>	<i>2001-02</i>	<i>2002-03</i>	<i>2003-04</i>
Total value of underdeclarations from Officers' assessments	£2.5bn (value) 107,002 (no)	£3.2bn (value) 103,031 (no)	£3.0bn (value) 84,362 (no)
Total value of voluntary disclosures (underdeclarations)	£0.52bn (value) 13,245 (no)	£0.61bn (value) 14,631 (no)	£0.67bn (value) 14,780 (no)

The total value of repayments made to businesses which includes the amount of overpayments is shown below, together with the percentage of assessment and disclosure errors resulting in overpayments.

	<i>2001-02</i>	<i>2002-03</i>	<i>2003-04</i>
Total value of repayments	£43.8bn	£44.7bn	£44.5bn
Percentage of all errors resulting in overpayment (by value)	25%	25%	25%
Percentage of all errors resulting in overpayment (by numbers)	23%	23%	24%

Question 125 (Mr Davidson): Action taken against professional advisors

The Number of Investigation cases undertaken where accountants and legal representatives and tax advisors have been involved in a professional context

<i>Year</i>	<i>Criminal investigations</i>	<i>Civil evasion investigations</i>
2001-02	14	1
2002-03	10	0
2003-04	8	4

Of these 37 investigations

- 24 involved VAT offences,
- 11 money laundering, and
- 2 excise offences.

The criminal cases lead to custodial sentences of over 41 years and confiscation orders of £8.7 million and in the civil cases civil evasion penalties of over £200,000.

Question 126 (Mr Field): Accreditation of officers involved in anti-fraud work

All our internal investigators undertake professional training to achieve status as an Accredited Counter Fraud Specialist (ACFS) in association with Portsmouth University and the NHS Counter Fraud & Security management Service.

During early 2001 our Internal Investigation Division negotiated with the NHS Counter Fraud & Security Management Service (as is now) for our investigators to undertake its formally accredited training. This covers “Investigation Law and Procedures”, “Principles of Good Practice”, “Investigative Interviewing”, and “Proactive Evidence Gathering” and supplements our internal training. We use the accreditation route to ensure our overall professionalism, and to identifying and reflect good practice.

There are two levels of certification. Award of ACFS is achieved through formal classroom and practical training. Working towards an advanced level of certification is optional and follows a course of academic study (distance learning) with Portsmouth University. This achieves status as a “Certified Counter Fraud Specialist” (CCFS) together with the academic award of a “Certificate of Higher Education in Counter Fraud & Criminal Justice Studies”.

Currently all our internal investigators undertake training to ACFS accreditation level. Since 2001:

- 22 staff have been awarded ACFS.
- 2 staff have been awarded CCFS and the Certificate in Higher Education and further 6 staff are nearing the end of their academic study towards it.
- We also have one investigator who is in the second year of a full degree programme¹.

Since 2003 all our Intelligence staff follow the same route of accreditation and professional award.

Question 127 (Mr Field): Accreditation of officers involved in anti-fraud work

Following the Butterfield Review of investigations and prosecutions undertaken by HM Customs, Customs has accepted and is implementing all of the recommendations made, including those relating to investigation training. These concluded that while the Basic Investigation Training (BITS) provided to investigators is reasonably thorough and is regularly updated, it needed supplementing with:

- Regular refresher training for investigators every five years.
- Specific training geared to particular key jobs within investigation, to include a written test before an officer is allowed to take up the new post.
- Training to reflect changes in the criminal justice system.

To address these recommendations Customs is developing professional skills that build on the Police Skills and Standards Organisation (PSSO) National Occupational Standards. We joined the community of police and law enforcement forces covered by the scope of the PSSO in August 2003.

PSSO are not themselves an accreditation body, but have assumed the role of Standards Setting Body by developing a comprehensive development programme to establish a suite of National Occupational Standards covering all policing roles. In the Police Services of England, Wales and Northern Ireland the suite of National Occupational Standards is being used as the basis for the development of nationally recognised qualifications, and perhaps the development of a scheme of Professional Registers, led by the Police Training Development Board.

At the present time we do not have any accredited external fraud investigation training or accredited external fraud investigators. We do have a small number of officers who have completed an investigation NVQ. We are however, looking to obtain external accreditation of training and externally recognised qualifications for all our external investigation staff. We aim to achieve this by selecting, through open tender, an accreditation body approved by PSSO to cover Investigation training, most likely a University.

The Counter Fraud qualification referred to by Mr Field is a Government sponsored accreditation programme set up by the NHS and DWP in association with Portsmouth University to be an Accredited Counter Fraud Specialist (ACFS). All our Internal Investigation and Intelligence staff undergo this accreditation process (see supplementary note to Question 126).

Question 128 (Mr Field): Referring accountants to their professional bodies

In line with the current data protection legislation the Department has adopted strict guidelines relating to disclosure of such information. Under these guidelines, it is possible for breaches of professional ethics by accountants and other professionals such as lawyers and insolvency practitioners to be reported to their parent regulating bodies. In general terms, such disclosures will only be made where:

- specific professional ethics or conduct have been seriously breached; and
- there is sufficient evidence to substantiate the breach; and

¹ Portsmouth University recently developed a degree course—Bsc (Hons) in Counter Fraud & Criminal Justice Studies. The ACFS award constitutes foundation level training and allows automatic entry on to the “optional” degree programme.

— there is an overriding public interest for making the disclosure;

Under these guidelines, Customs has reported three accountants to their professional bodies. In one case the accountant was struck off by the Institute of Chartered Accountants. In the second the accountant was cited, reprimanded and fined by his professional body. In the third case the accountant, a trainee passing himself off as a qualified accountant, became involved in a money laundering fraud. Following criminal proceedings, the accountancy firm employing the trainee was reported to the ACCA in relation to the trainee's conduct and lack of supervision by the firm.

In addition, we have an agreement with the Insolvency Practitioners Control Unit (IPCU), part of the DTI based in London, that we will submit a detailed report to them on any Insolvency Practitioner (IP) whose professional conduct we deem to be unsatisfactory, and who has not satisfactorily responded to our requests to bring their conduct up to an acceptable level. The IPCU will then pass on the report to the licensing body of the particular IP involved. By this method, a central record of any complaints, and their outcome, is kept both here and at the DTI. "Unsatisfactory conduct" in this context is defined by a set of criteria that was agreed with stakeholders, including the IPCU, when this system was set up.

To date, we have only one completed case, with another ongoing. In the one completed case, the IP was reprimanded and fined £8,000 by his licensing body.

While it may seem surprising that so few professional practitioners and advisors have been referred to their professional body, it should be remembered that such action is only taken when all other attempts to improve performance has failed, or the actions of the practitioner constitute a serious breach of professional ethics.

These disclosures are in addition to action taken against professional advisors involved in criminal activities (see supplementary note to Question 125)

Question 137 (Mr Field): The bonus system

The main method for recognising and rewarding performance in Customs and Excise is through our performance pay system. We also have a 'manager's reward' system and have recently trialled team bonus payments. These are described below together with the considerations that led to our current policies.

PERFORMANCE PAY (REFERRED TO AS OUR "BONUS" SYSTEM)

We have a performance pay system that is based on an annual assessment of an officer's achievement against a set of mainly operational objectives. The objectives are standard for each grade and work area, and are described in a series of "role profiles", which set out the role and responsibilities of each job, together with the operational objectives and the key competencies required for the work. These are qualified by performance indicators that adapt the objectives by setting specific targets that take account of an individual's levels of training and experience.

Staff who perform well against their operational objectives, observe certain behavioural standards and also achieve any personal development objectives set for them, receive a "Top" or "Good" marking and, as a result, are awarded an annual performance pay increase. This includes a progression payment that moves them up their pay range to the pay range maximum. The top 10% of performers receive an additional bonus. Last year this was 2.5% of their salary.

Our pay system includes a means by which staff that fail to achieve their objectives or only just do so, may receive a smaller pay increase than those who perform in line with expectation. A key challenge in designing these arrangements is to find the appropriate financial balance, within available funding, between the level of performance payments made to top and good performers. We reward, in a meaningful way, the work achievements of the vast majority of our staff who deliver the Department's PSA objectives whilst also acknowledging the greater contribution made by those whose performance significantly exceeds expectations.

MANAGER'S REWARD SCHEME

The Manager's Reward Scheme provides managers with a facility to acknowledge particular achievements as they occur during the course of the year by making a relatively small payment to staff (£100) and publicising this. The scheme allows awards to be made at the time of the achievement and is primarily about recognition rather than reward. The aim is to enable managers to recognise a specific job well done that might otherwise be lost in the year as a whole. Payment can be to individuals or a team.

TEAM BONUSES

A report "*Incentives for change*" produced by John Makinson for the Government's Public Services Productivity Panel, called for pilot trials of a team bonus system by Customs and two other departments. These were held in Customs in 2001-02 and 2002-03. We concluded that while the system produced some positive benefits, the particular arrangements for team bonuses that were trialled did not fit with our current

organisation and structure, and were costly to administer. The Inland Revenue use Team Bonus arrangements but have a different system from the one we were asked to trial. Our intention is to look at the team bonus concept in the context of setting up HM Revenue and Customs.

CONCLUSION

Our current performance pay system, which looks at an officer's whole year performance, avoids arguments about an officer's impartiality when implementing customs and taxation policies. Our systems will be reviewed when HM Revenue and Customs is set up.

Supplementary information for the Public Accounts Committee in response to Question 138 concerning legal fees in prosecution cases

Question 138 (Chairman): How much paid out in legal fees to independent barristers and solicitors for the 69 prosecutions that were secured last year?

LEGAL FEES PAID IN VAT PROSECUTION CASES

<i>Year</i>	<i>Total</i>
2001–2002	£2,284,090.59
2002–2003	£3,066,399.80
2003–2004	£2,874,584.84
Total over 3 years	£8,225,075.23

- The figures relate to VAT Prosecutions only.
- The figures included all ongoing or completed case during this three-year period. (eg in 2002–03 this equaled 377 VAT prosecutions).
- All fees paid between 1st April- 31st March in each financial year were included for this purpose.

2 June 2004