



House of Commons
Committee of Public Accounts

Tackling fraud against the Inland Revenue

**First Report of
Session 2003–04**

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

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The Committee of Public Accounts

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Summary

Introduction

The Inland Revenue collect around one half of all public revenue: £214 billion in direct taxes and national insurance contributions in 2001–02 from around 30 million taxpayers. They also distributed £5.7 billion in tax credits to over one million claimants on low incomes, and this is set to rise to over £15 billion by 2003–04, following the introduction of new tax credits from April 2003. The aim of the Revenue is to maximise the compliance of taxpayers and other customers with the regulations governing tax and tax credits. They face various risks of non-compliance including error, negligence and fraud. Fraud involves the deliberate evasion of tax and the deliberate claiming of tax credits to which claimants know they are not entitled.¹

On the basis of a Report by the Comptroller and Auditor General² and a memorandum from the Revenue,³ we examined the Department on progress in assessing the risks of fraud and developing a strategy to counter it; the measures being taken to tackle tax fraud and fraud in tax credits; and their use of sanctions and publicity to deter fraud.

1 C&AG's Report, *Tackling fraud against the Inland Revenue* (HC 429, Session 2002–03) paras 1, 2, 1.4–1.5

2 C&AG's Report, *Tackling fraud against the Inland Revenue* (HC 429, Session 2002–03)

3 Ev 15–16

Conclusions and recommendations

1. The Revenue have not estimated the direct tax gap, which is the difference between full and actual compliance with the tax rules. While there are recognised methodological problems, overseas research and the Revenue's random enquiry programmes now underway on individual taxes offer a way forward in producing for the first time estimates of the scale of losses from fraud and other non-compliance. The Revenue should focus their work on making a reasonable estimate of the tax gap so that they can judge the effort needed for a given reduction in losses.
2. The Revenue first set out their tax compliance strategy in the 1980s. Their business has since expanded significantly and the environment in which they operate has changed, with developments in the law, access to information and information technology. They should set a date for completing and publishing their revised compliance strategy including an explicit strategy for preventing, detecting, investigating and deterring fraud, and the performance measures by which they will assess achievement.
3. The low number of fraud investigations and prosecutions is not commensurate with the potential sums at stake in lost revenue. Nor has the overall scale of work kept pace with the expansion in the Revenue's business. Investigation work on tax fraud appears to have reduced as work on tax credit fraud has increased, despite additional resources being provided. The financial returns on investigations suggest that it would be cost-effective to do many more. The Revenue should increase the level of investigations and prosecutions sufficiently to permit a meaningful evaluation of the effects of doing so. They should also seek to increase the effectiveness of such work by greater publicity to heighten public awareness about the risk of detection and punishment for those who commit fraud.
4. To date the results of work aimed at using the new offence of evading income tax, which is particularly relevant in tackling fraud in the shadow economy, have been limited. In increasing the level of prosecutions the Revenue should extend the coverage across all taxpayer groups, to include all sizes of business and lower value cases, so that deterrence is maintained across the entire taxpayer base.
5. There is a difficult balance to be struck in offering those in the shadow economy the incentive to regularise their tax affairs while not giving them an unfair advantage over those who have complied fully. While it remains important to punish serious abuse, the Revenue should also examine opportunities to secure higher levels of voluntary compliance and payment of tax due, for example by improving arrangements for payment by instalment and interest on arrears of tax.
6. The Revenue face a growing threat from fraud involving offshore accounts and structures. The Revenue should work closely with the banking and credit card industry and professional representative bodies to ensure the reporting requirements of recent legislation are fully understood and acted upon. If difficulties remain they will need other ways to obtain the information they require, such as a statutory duty for financial institutions who provide offshore accounts to disclose the identify of account holders.

7. The Revenue expect prosecutions for new tax credit fraud to rise as new powers take effect, but they see civil penalties as their primary weapon. The Department for Work and Pensions prosecute more than twenty times as many cases per £100 million spent. The Revenue should work with the Department for Work and Pensions to secure greater consistency in the scale and nature of sanctions applied.
8. To those involved in or contemplating fraud the chances of getting caught could appear minimal, since the Revenue only carry out 400 serious fraud investigations and 60 prosecutions a year on a customer base of more than 30 million. The 12:1 financial return achieved by the Special Compliance Office, which excludes the yield from criminal prosecution work and wider deterrent effects, suggests that a substantial increase in investigation activity would be cost-effective. More prosecutions should also bring opportunities to make greater use of the confiscation and restraint powers to deprive fraudsters of the wider proceeds of their crime.
9. The enforcement of fines imposed by the courts for convicted fraudsters is important in building an effective deterrence. Although it is not the Revenue's role to collect the fines, they should nevertheless work with the Department for Constitutional Affairs to find out the level of fines actually paid. Without that knowledge they can hardly judge the effectiveness of prosecutions as a deterrent, or strike the right balance between prosecution and civil penalties.
10. The Revenue have not followed the examples of the Department for Work and Pensions and HM Customs and Excise in undertaking national campaigns to raise public awareness about the unacceptability of fraud and the consequences of getting caught. A pilot project could test the cost-effectiveness of such a campaign and show whether there is a case for a wider exercise. The Revenue should also publicise their awareness of new forms of fraud and evasion schemes, as a deterrent to further use, and the results of their compliance activities, drawing on the experience of their overseas counterparts such as the US Internal Revenue Service.

1 Progress in assessing the risks of fraud and developing a strategy

1. The Revenue face various risks of tax fraud. It can be systematic and premeditated involving deliberate concealment of income and conspiracy by people in authority such as company directors and their professional advisers. It can also be opportunistic, for example a self-employed trader accepting cash and then under-reporting sales. Frauds on tax credits have so far tended to be low value opportunistic attempts to claim credits to which the individual is not entitled, although there is some evidence of organised gangs using multiple fictitious identities.⁴

2. In recent years both HM Customs and Excise and the Department for Work and Pensions have made estimates of losses from fraud and other non-compliance in indirect taxes, such as VAT, and welfare benefits, such as Income Support. The Revenue, however, have not estimated the level of fraud or the “tax gap”, the difference between full compliance with tax regulations and actual compliance.⁵

3. HM Customs & Excise have estimated the tax gap on VAT by calculating the theoretical tax liability on total expenditure in the economy, drawing on Office for National Statistics data, and comparing this with actual VAT receipts. The Revenue have not been able to use a similar approach for direct taxes as no independent baseline exists to assess the level of income or profits that should be declared and the level of tax due. While research continues in the UK and overseas into methods of estimating the tax gap and the shadow economy, there is as yet no recognised best estimation method. The Revenue have therefore been identifying areas of particular risk through programmes of random enquiries on tax returns for individual tax streams. Having strengthened their analytical capacity they were now seeking a better way of estimating the tax gap.⁶

4. The random enquiry programme on Income Tax Self Assessment has been their most longstanding work, with results for three years from 1996–97 to 1998–99. The resulting estimates of tax at risk for each year have fluctuated over time. None of these was finalised because cases took a long time to settle. The larger more complex cases take the longest time to settle, so the Revenue anticipate the likely results in producing their initial estimates. As cases were completed and the actual results fed in the overall estimates of tax at risk had changed. Latest estimates indicated around £2.5 billion at risk each year, roughly equivalent to 5% of the tax that should have resulted from Income Tax Self Assessment tax returns submitted each year. 5% of returns accounted for 70% of the tax at risk.⁷

4 C&AG’s Report, paras 1.7, 1.9

5 *ibid*, paras 1.1, 1.11; C&AG’s Report, *Tackling benefit fraud* (HC 393, Session 2002–03) paras 1.10 –1.16; HM Customs & Excise, *Protecting indirect tax revenues*, November 2002

6 C&AG’s Report, paras 1.11–1.13, 1.20–1.21; HM Customs & Excise, *Measuring indirect tax losses*, November 2002; Qq 2, 113

7 Ev 15

5. The Revenue estimated that in total one third of taxpayers had not complied, which they believed to be a reasonably accurate estimate. The figure had remained broadly the same in successive estimates and it was consistent from year to year. But the monetary estimates of tax at risk were much less precise. The results were based on a statistical sample of 6,000 returns, out of the 9 million returns each year. A four-fold increase in the sample would be needed to get a significantly better estimate. There were cost constraints on increasing the sample, both for the public as inevitably some compliant customers would be selected for enquiry, and for the Exchequer because of the opportunity cost of diverting resources away from their risk based enquiries.⁸

6. The random enquiry programmes have helped the Revenue to understand better the compliance risks across different customer groups. This understanding has informed their activities for helping customers to comply and their selection of returns for targeted enquiry. Similar random enquiry programmes have been introduced for Corporation Tax and employers' PAYE and National Insurance contributions. Random enquiry programmes will also play a role in tax credits.⁹

7. HM Customs and Excise and the Department for Work and Pensions have published strategies and targets for reducing losses from fraud and other non-compliance. For some years the Revenue have also had a compliance strategy for tax. With the expansion of their business and greater opportunities to exchange more information with other government departments and match their own data sources, they decided during 2002 to modernise their compliance strategy. Their aim is to provide business managers with a framework and better understanding of the risks of fraud and other non-compliance. They plan to compare the risks for each part of the Department and target available resources on those risks.¹⁰

8 Qq 3, 12–15; Ev 15

9 C&AG's Report, para 1.20 and Figure 6; Ev 15

10 C&AG's Report, para 1.17; C&AG's Report, *Tackling benefit fraud* (HC 393, Session 2002–03) paras 1.10–1.16; HM Customs & Excise, *Protecting indirect tax revenues*, November 2002; Q 4

2 Tackling tax fraud

8. In 2001–02 the Revenue spent £428 million on activities to tackle non-compliance and achieved an overall yield to cost ratio of 8.3:1. This ratio was lower than in previous years but the Revenue expected recent initiatives to result in increased yield in future years. Over 80% of these resources are deployed on compliance work by local tax offices which carry out targeted enquiries on tax returns. These activities generate a yield: cost ratio of 3.6:1 in additional settlements and penalties. The remainder is spent on compliance activities by the Revenue’s Specialist Offices, which deal with enquiry work on large and specialist businesses and on tax credits, and the Special Compliance Office whose main role is to investigate serious fraud and complex non-compliance.¹¹

9. The Special Compliance Office investigates between 400 and 450 fraud cases a year, plus 325 to 450 avoidance or other non-fraud cases. In 2001–02 they recovered 12 times their cost. This excludes the proceeds from criminal prosecutions such as fines and confiscations, and future savings and the wider deterrent effects that may result from their work. The yield: cost ratio was lower than in previous years due to various factors including increased costs associated with new investigation work on shadow economy cases and tax credits.¹² On tax fraud the Revenue face two major risk areas: the shadow economy where people use cash transactions to evade tax, and the use of offshore accounts and structures to evade tax.¹³

a) Tax fraud in the shadow economy

10. Those operating in the shadow economy may be committing fraud against more than one department, for example by working for cash on which they do not pay income tax, while also claiming benefits to which they are not entitled. Businesses may use cash transactions to evade both direct taxes and VAT. A report by Lord Grabiner in March 2000 made a series of recommendations to combat tax and benefit fraud.¹⁴

11. The Revenue have made progress in tackling the shadow economy in two main ways: by providing education and support to people setting up in business to help them to comply with the law; and working with HM Customs & Excise and the Department for Work and Pensions in joint shadow economy teams to detect and investigate fraud. They had set up specialist teams across the country to identify higher risk areas and sectors, including those not registered for tax and “moonlighting”. These teams could target investigation work, for example on cash businesses. Where they suspected someone was not declaring all income, they could build up a profit figure by analysing the economics of the business and examining the premises and purchases of materials which were more likely to be declared.¹⁵

11 C&AG’s Report, paras 7, 1.25, 2.2 and Figure 5

12 *ibid*, paras 2.21–2.22 and Figure 15

13 *ibid*, para 1.14

14 *ibid*, paras 1.11–1.12, 2.8; Qq 5, 91

15 C&AG’s Report, paras 2.9, 3.6; Qq 5, 92–93

12. In 2001 the Revenue received additional funding of £2 million to pay for extra staff to conduct investigations with a view to applying the new criminal offence of being knowingly concerned in the fraudulent evasion of income tax. This offence can be tried in magistrates' courts, thereby allowing the Revenue to consider prosecution in a wider range of cases, including fraudulent activities in the shadow economy. The lead time for using the new offence, and for the training of investigators, has meant that results to date have been limited. Referrals to the new teams have also not yet been as high as expected, with difficulties in defining appropriate referral criteria for local staff.¹⁶

13. The tax implications of legitimising activity in the shadow economy can soon become a significant barrier to registering with the authorities. The Revenue had decided against a tax amnesty because the experience of other fiscal authorities had not been encouraging, and it was difficult to justify letting off people who had not paid their way. Their main concern however was to ensure that people were registered for tax and would remain so. Thus in the construction industry scheme they had not enquired too closely about past employment records when bringing people into the formal economy. They would take action if they detected evasion, but if someone made a full voluntary disclosure, the Revenue would abate the penalties, according to the gravity of the offence and the co-operation given. The Tax Faculty of the Institute of Chartered Accountants in England and Wales has suggested that people might be more likely to legitimise their activities if there was more flexibility in imposing interest on overdue tax and if the granting of instalment arrangements beyond 12 months was more formalised and easier to anticipate.¹⁷

b) Tax fraud in the use of offshore accounts

14. Around a quarter of serious fraud cases investigated by the Special Compliance Office involve the use of offshore accounts and structures. This is not a new type of fraud but the Revenue's concerns have grown in recent years as the value of tax involved and the complexity of concealment methods have increased. While there are no robust estimates, it is likely that significant numbers of frauds remain undetected.¹⁸

15. The Special Compliance Office has over the years recovered millions of pounds from civil fraud investigations involving offshore accounts, and secured several highly successful prosecutions. In one case an individual was sentenced to seven years' imprisonment and his advisers in the UK and abroad were also prosecuted. The Revenue considered that the publicity attracted by this case had affected the behaviour of individual tax evaders and professional advisers. The 2003 budget provided the Revenue with additional funding of £66 million over three years to generate additional revenue of £1.4 billion from tackling different forms of non-compliance. Dealing with offshore evasion and avoidance would be a major part of this work.¹⁹

16. Experience in the United States suggests that there is considerable evasion through tax haven based credit card accounts. The US Internal Revenue Service have made significant progress in obtaining information on such accounts. Issuing information notices on one

¹⁶ C&AG's Report, paras 2.13–2.16

¹⁷ *ibid*, paras 3.7–3.8, 3.27; Q 103

¹⁸ C&AG's Report, para 3.15; Q 104

¹⁹ C&AG's Report, para 3.17; Qq 11, 89

credit card company yielded details of 230,000 offshore accounts and 1.7 million transactions. As a result the Internal Revenue Service estimated that two million US citizens may have offshore debit or credit card accounts, compared with the 170,000 tax return filers who declared such accounts in 2000.²⁰

17. The Revenue do not know how many people have tax haven bank accounts and credit card accounts. One difficulty has been that their information powers were effective only if the information about accounts was held onshore. They have made progress in developing arrangements for exchange of information within the European Union and the Organisation for Economic Co-operation and Development, and in building relationships with the Channel Islands and the Isle of Man authorities to assist their investigations. Following the introduction and continuing development of money laundering legislation the Revenue have access to much more information through the National Criminal Intelligence Service, to whom they have seconded staff to examine disclosures received.²¹

18. Probably all of the major banks in this country offer offshore accounts, but they have not had to tell the Revenue about clients with an offshore account. In their investigations the Revenue sought to establish whether the route to the offshore account involved a UK bank or professional adviser, who might have other clients with offshore accounts, and how they could use their information powers. The Revenue considered that making it a bank's duty to inform them of every offshore account holder would provide useful information to help them conduct investigations. But the banks might have concerns for customer confidentiality because not everyone with an offshore account would be concealing income from the tax authorities.²²

20 C&AG's Report, para 3.20

21 Qq 11, 104

22 Qq 105–110

3 Tackling fraud in tax credits

19. Working Families' and Disabled Persons' tax credits were introduced in 1999 and were replaced by the new Child Tax Credit and Working Tax Credit in 2003. As tax credits were relatively new, the Inland Revenue did not know the level of fraud but they expected to gain over time a better assessment of the problem.²³

20. In both the old and new tax credits, there have been fraud risks, from people providing false information. The most common frauds have been understated or undeclared income or capital, undeclared or fictitious employment, overstated hours, undeclared or fictitious partners, fictitious children and misrepresented child care. Collusion between employers and employees has also been a risk but the Revenue have found few examples.²⁴

21. The Revenue have carried out a benchmarking exercise on non-compliance in the old tax credits involving the random selection of cases for review followed by full enquiry where non-compliance was suspected. The Revenue's aim was to understand the effectiveness of the regime in combating error and fraud to inform the design of the new tax credits and their compliance strategy, which they expected to complete later in 2003. The new tax credits legislation has provided them with full random enquiry powers and they expect to have the first results of a random enquiry programme after the end of 2004–05. They will not be able to establish a baseline for fraud and error until they have identified the population for Child Tax Credit at the end of 2005–06.²⁵

22. The Revenue have sought to develop more robust systems to identify fraud in the new tax credits, with inbuilt risk and verification processes including cross checks to their own data and to data held by the Department for Work and Pensions. For example, they have introduced automatic checks for undeclared partners against records of numbers of adults living at an address.²⁶

23. The Revenue can recover overpayments by reducing any ongoing entitlement, and will soon be able to recover by adjusting PAYE codes. As with tax non-compliance, their primary sanction is to recover overclaimed tax credits through civil investigation. The penalty in such cases can be up to 100% of the credits over-claimed as well as recovery of the credits and interest.²⁷

24. In 2000 the Revenue received additional funding of £1.9 million for extra staff to work on tax credit frauds. By December 2002 they had prosecuted in only 57 cases on working families' tax credit reflecting the time required to recruit and train new investigation staff and for the threshold value for serious frauds to be reached and offences investigated. Their rate of prosecutions in 2001–02 was one prosecution for every £200 million of expenditure compared to one for every £8 million of benefit expenditure by the Department for Work and Pensions. The Revenue expect the number of prosecutions to increase, having

23 C&AG's Report, para 1.5; Qq 43–44, 66

24 Qq 39, 43–44, 55–56

25 C&AG's Report, para 1.24 and Figure 6; Qq 66; 111–112

26 Q 40

27 Qq 41–42, 68–74

recruited and trained staff and obtained new third party information powers and a new criminal offence for tax credit fraud.²⁸

25. The Revenue secured 56 convictions in the 57 cases prosecuted. The penalties were decided by the courts and the Revenue do not know how many people have actually paid any fines imposed, on the grounds that it is not their responsibility to follow these up. Previous enquiries by this Committee have shown that although fines account for some 70% of all sentences imposed by courts, only some 60% of fines are actually paid.²⁹

28 C&AG's Report, *Tackling benefit fraud* (HC 393, Session 2002–03) Figures 3, 23; C&AG's Report, paras 1.5, 2.20, 2.51–2.52; Inland Revenue Annual Report for year ending 2001–02; Qq 55–56, 59–66, 68–74

29 68th Report from the Committee of Public Accounts, *Collection of fines and other financial penalties in the criminal justice system* (HC 999, Session 2001–02); Qq 60, 68–74

4 Deterring fraud through sanctions and publicity

26. The Revenue's main sanction against serious tax fraud is the imposition of civil penalties, involving payment of the tax due and any financial penalty and interest. Civil investigations, conducted under the "Hansard" procedure, give taxpayers the opportunity to disclose fully irregularities in their tax affairs no matter how serious. Failure to do so carries the risk of the civil route being withdrawn and an investigation started with a view to criminal prosecution. The Revenue are taking a similar approach on tax credit fraud. They conduct around 300 civil investigations a year which take between two to three years to complete generating some £90 million to £100 million in additional revenue.³⁰ Following a recent judgement by the Court of Appeal, the Revenue are carrying out a review of the implications for their investigations under the Hansard procedure.³¹

27. The Revenue prosecute only in the most serious cases. They see civil penalties as a more efficient way of recovering evaded tax. The main aim of prosecution is to secure a conviction and achieve a wider deterrent effect. Such cases include, for example, those involving collusion and false documentation or committed by certain classes of individual such as professional advisors. Over the four years to 2001–02 the Revenue undertook 478 criminal investigations of tax and tax credit fraud, and prosecuted 245 defendants, of whom 183 were convicted.³²

28. By comparison, the Department for Work and Pensions prosecute around 12,000 cases a year for benefit fraud and achieve a conviction rate of 98%. The Revenue believe that benefit fraud cases are simpler to prove. The Department for Work and Pensions do not have the same civil penalties as those available to the Revenue, but can use other sanctions such as administrative penalties to require repayment of benefit overpayments plus a 30% penalty. They impose around 6,500 such penalties each year. The tax fraud cases the Revenue prosecute are complex, and preparing them to the state of proof needed for a criminal trial is a long and expensive process.³³

29. The Criminal Justice Act 1988 provided additional powers of confiscation and restraint to deprive convicted fraudsters of the proceeds of their crime. The Revenue successfully used a confiscation order for the first time in 2001 to recover the wider proceeds of crime. The tax lost to the Exchequer was £400,000 but the Revenue secured a court order for £1 million in misappropriated takings to be confiscated. The Revenue intend to apply to the courts for confiscation of the full proceeds of crime in future cases of this kind. They are also helping the new Asset Recovery Agency to develop their expertise.³⁴

30 C&AG's Report, paras 2.40–2.42 and Figure 18

31 Inland Revenue letter of 1 August 2003 to professional bodies: Cases where serious fraud is suspected: Inland Revenue Code of Practice 9

32 C&AG's Report, paras 2.43, 2.46–2.47; Qq 6–9

33 C&AG's Report, *Tackling benefit fraud* (HC 393, Session 2002–03) para 2.79 and Figure 24; 31st Report from the Committee of Public Accounts, *Tackling benefit fraud* (HC 448, Session 2002–03); Qq 6–9

34 C&AG's Report, para 2.56 and case example J; Qq 94–98

30. The Revenue's aim is that no one should assume they are immune from prosecution. The majority of their investigations have involved people in medium and small enterprises with ownership or control over the business or access to cash. Another significant group has included accountants, tax advisors and solicitors. The Revenue believe there have been no prosecutions of large businesses because the control environment is generally tighter in most large businesses in the UK. Moreover while companies might get involved in avoidance, sometimes artificial and on a large scale, the risks involved in engaging in evasion were high. Even so the Revenue have carried out civil investigations of tax fraud involving large businesses, for example individuals with complex personal tax affairs operating in large businesses and potentially fraudulent avoidance schemes.³⁵

31. The effectiveness of the Revenue's prosecutions and other penalties depends on achieving a wider deterrent effect by raising public awareness of the risks of detection and the consequences of being caught. They have tried to do so when they have obtained a conviction by issuing a press notice and publishing details on their website. They have often generated interest in the local media and in the specialist professional and trade press, but at the national level a conviction has only seemed to be of interest if it has involved a public figure.³⁶

32. The Revenue have also used publicity to raise the profile of their compliance work, for example by considering advance warning of new areas where they would be targeting work to encourage voluntary disclosure. But it might not always be appropriate to give advance warning because it might compromise the intended effect of such work. The large accountancy firms have also published advice on their websites for clients. Compared with some other fiscal authorities, such as the US Internal Revenue Service, however, the Revenue have published relatively little information on new and emerging threats and specific counter fraud activities.³⁷

The US Internal Revenue Service approach to publicity on tax fraud

The US Internal Revenue Service issue periodic "Tax Fraud Alerts" on their website, warning the public of the risks and costs of buying into tax evasion schemes as well as providing information on the latest "schemes, scams and cons". The Alerts set out in more detail the main strands of the Service's enforcement programme and the consequences of non-compliance. For example, for employment taxes, the relevant "Tax Fraud Alert" provides details of legal requirements, employer and employee responsibilities, examples of tax evasion schemes, and data on how non-compliance has been dealt with in the Courts, with reference to specific significant examples. The "Tax Fraud Alert" web page also publicises a free-call phone number for the public to report all instances of suspected tax fraud activity.

Source: National Audit Office

33. Unlike other departments, such as HM Customs and Excise and the Department for Work and Pensions, the Inland Revenue have not launched a national publicity campaign to raise awareness and change public attitudes towards fraud. They have been tracking the progress of these Departments' campaigns to assess whether a similar campaign against tax fraud would be worthwhile. Although they have yet to be fully convinced that such a

35 C&AG's Report, paras 2.31, 2.43, 2.50; Qq 99–100

36 C&AG's Report, para 3.29; Qq 10, 16–17

37 C&AG's Report, para 3.29 and Figure 27; Qq 18–24, 90, 102

campaign would give good value for money, they are actively considering a joint project with the Department for Work and Pensions.³⁸

38 C&AG's Report, para 3.28; Qq 10, 18–21, 102

Formal minutes

Monday 1 December 2003

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Allan
Mr Richard Bacon
Jon Cruddas
Mr Frank Field
Mr Brian Jenkins

Mr Nigel Jones
Jim Sheridan
Jon Trickett
Mr Alan Williams

The Committee deliberated.

Draft Report (Tackling fraud against the Inland Revenue), 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 33 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the First 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 3 December at 3.30 pm

Witnesses

Monday 9 June 2003

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Sir Nicholas Montagu KCB, Mr David Hartnett CB, and Mr John Middleton,
Inland Revenue

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Oral evidence

Taken before the Committee of Public Accounts

on Monday 9 June 2003

Members present:

Mr Edward Leigh, in the Chair

Geraint Davies
Mr Brian Jenkins

Mr David Rendel
Mr Gerry Steinberg

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

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

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL:

Tackling fraud against the Inland Revenue (HC 429)

Witnesses: **Sir Nicholas Montagu** KCB, Chairman, **Mr David Hartnett** CB, Deputy Chairman and Director General (Policy and Technical) and **Mr John Middleton**, Director, Cross Cutting Policy and Compliance Strategy, Inland Revenue, examined.

Q1 Chairman: Welcome to the Committee of Public Accounts. I apologise, Sir Nicholas, to you and your colleagues that we delayed the start so that members could attend the Chancellor's important statement on the euro. You were warned in advance, so I hope it has not been too long a wait. We are very grateful to you for coming this afternoon and talking to us about the important subject of fraud against Inland Revenue. Could you please start by introducing your colleagues?

Sir Nicholas Montagu: On my right is Dave Hartnett, who is getting to be a veteran of this Committee. He is Deputy Chairman and Director General for technical and policy matters. On my left is John Middleton, who is Director, Cross Cutting Policy and Fraud Champion. Until recently he was Director of our Special Compliance Office.

Q2 Chairman: Could you please start by turning to page 15 and looking at paragraph 1.11; this subject is also dealt with in paragraphs 1.20 and 1.21. Customs and Excise and the Department for Work and Pensions do have estimates of their losses from fraud and error, but you do not seem to know what the Inland Revenue are losing. Why not?

Sir Nicholas Montagu: Because it is a very different sort of department from both Customs and the Department for Work and Pensions. Customs are able to infer the so-called tax gap from transactions that they know take place and then compare that against tax receipts. With us, and indeed all other tax administrations, the national income statistics are inferred from tax rather than the other way round. What we are trying to do, as I think Sir John recognises in his Report, is to adopt a much more bottom-up approach than that top-down one you have mentioned. By that I mean identifying and pinpointing areas and sectors of particular risk,

especially getting results from our random inquiry programme, but we have also substantially strengthened our analytical capacity and we are looking to see whether we have any better way of looking at what the tax gap might be.

Q3 Chairman: For instance, we see in paragraph 1.21 on page 18 that you could do more random enquiries into tax returns, could you not, which would give you a better idea of what is going on, would it not?

Sir Nicholas Montagu: We could. Equally, in this Committee before now I have had implicit criticism for doing random enquiries at all. They do take up quite a lot of people's time—on people who may be perfectly compliant. What one has to balance with random enquiries is the need to get a good fix on the risks and what the tax at risk may be, with the need to avoid unnecessary burdens on people. For example, that is why we do a sample of just over 6,000 random enquiries on self-assessment returns each year.

Q4 Chairman: Let us now look at paragraph 1.17 on page 16. You will see that both the Departments I have referred to have fraud strategies. When will you have one for the Inland Revenue?

Sir Nicholas Montagu: In one sense we have a fraud strategy. It is not something which is going to spring fully fledged from the head of John Middleton. As Sir John's Report notes, we have had a compliance strategy for some years, and obviously we have had strategies to combat tax fraud and we are now building in strategies to combat tax credits fraud. What has changed is that our business has expanded and also legislation has given us access to far more exchanges of information with other government departments in recent years through increased

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statutory gateways, plus our own capacity to marry up different data sources that we own through data warehousing. This has meant that we have a lot more at our disposal. For that reason we decided in the second half of last year to modernise our compliance strategy completely in order to draw together all the strands and approach our new business in a coherent way. One of John Middleton's key responsibilities is to carry the development of that strategy forward.

Mr Middleton: The approach is to provide a framework for business managers around the Department better to understand the risks of fraud and other forms of non-compliance. They will be different in different areas of the Department. For example, in the Large Business Office, the major risk is probably the risk of tax avoidance, whereas in another part of the business tax avoidance, say in relation to small businesses, it will be less of an issue and the critical issues we will be looking at there are either simple error or possibly evasion. It is to understand the risks for each part of the Department try to gauge them and then determine what outcomes we want to achieve with the resources we have and then to target the resources against the risks and be flexible in how we deploy those, so far as we are able to.

Q5 Chairman: May I ask about the shadow economy? Obviously there is a lot of interest in what goes on in the shadow economy. This is dealt with on page 25 in paragraph 2.8. How effective has your action been in tackling fraud in the shadow economy?

Sir Nicholas Montagu: It has been increasingly successful. As Sir John notes in his Report, no fiscal authority in the world has successfully identified the size of the shadow economy, and we have talked about this before. Sir John says for example that we have made good progress in implementing Lord Grabiner's recommendations and there are several other references in the Report. Essentially we are tackling the informal or shadow economy on a number of fronts. A very important front is the preventive one, the work that our business support teams do across the country in educating people setting up in business, keeping in touch with them, answering their questions, making sure that they stay on the right side of the law. Sir John also comments on the success of the work we have done on the construction industry scheme. The other area I would particularly want to emphasise is the joint shadow economy teams with Customs, but also that we now have our own risk intelligence and analysis teams right across the country, drawing on various sources of data, identifying risky sectors and areas for the right track teams to target, to go in, get people sorted out and the right track team will keep in touch with people for a couple of years afterwards, making sure that they stay on the right side of the economy, in other words in the non-shadow economy. I could keep on for a long time but will not. Essentially we have a pretty big armoury of weapons which are a mixture of enabling, in other words helping people to understand and stay okay, and regulating where they do not.

Q6 Chairman: So far we have discussed assessing fraud and then detecting it. Let us now look at prosecutions and what you achieve in terms of prosecuting individuals. We can find information on that on page 39 in paragraph 2.47. What I cannot understand is how you can justify only prosecuting 60 individuals for fraud each year, when the Department for Work and Pensions, for example, prosecute 11,000?

Sir Nicholas Montagu: Again, the two Departments are very different. Sir John notes in his Report that the use of civil penalties is especially effective, but the Department for Work and Pensions do not have that sanction. He also says that with a conviction rate of around 75% we appear to have struck a reasonable balance.

Q7 Chairman: Let us just stop there. You achieve 75%, they achieve 98%. You keep telling us that things are very different with the Inland Revenue but that still seems quite a difference. You are only prosecuting 60 individuals for fraud each year, you only get a 75% conviction rate. Members might well feel that you are not being as rigorous as you might be.

Sir Nicholas Montagu: That would not be fair, if they did feel that way. I again invoke the fact that Sir John clearly would, I am sure very respectfully, disagree with members were they to express such a view.

Q8 Chairman: He would never dare.

Sir Nicholas Montagu: It is wonderful to invoke Sir John when he is not here. In many ways benefit fraud cases are simpler to prove. Point one. Point two, the Department for Work and Pensions cannot recover overpaid benefit in the way that we can in many cases without prosecuting. What we do is have a presumption that we will go for civil penalties because they are extremely effective, they are a good deterrent sanction and we will prosecute only in the most serious cases. Those most serious cases—and I can give examples of exactly what type of cases we will prosecute—of tax fraud tend almost by definition to be complex. Preparing them to the state of proof for a criminal trial is a long and expensive process. It is much more economical to take civil penalties. If you are dealing with complex cases, there is an element of risk; you cannot be sure of 100% convictions.

Q9 Chairman: May I just stop you there and ask a question which interests me? You are giving all these reasons why it is more difficult for you to prosecute; it is a very different beast. You do not rely on the philosophical point of view, do you, that here you are dealing with people's own money while in the Department of Work and Pensions these claimants are dealing with other people's money. Does that influence your thinking at all?

Sir Nicholas Montagu: Absolutely not at all. In fact I do not think we are dealing with people's own money, I think we are dealing with the state's money, money due to the state which has wrongly not been paid.

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Q10 Chairman: Other departments have conducted publicity campaigns to try to change public attitudes towards fraud. I do not think you have. This is dealt with in paragraph 3.28. Is there some reason for this?

Sir Nicholas Montagu: Quite honestly I think the jury is out on publicity campaigns. We do work with the Department for Work and Pensions on publicity and we shall be interested to see what comes out from them as a result of publicising fraud. Early results do not indicate enormously that publicity has great effect, but, that said, we do try to get publicity in all sorts of ways. In particular, we always issue a press notice when we obtain a conviction, we would publish details of convictions on our website where appropriate, our local broadcasters right across the country would certainly ensure local publicity for local prosecutions and that engenders a lot of interest. The real difficulty is that, at the national level, national newspaper editors have told us that a conviction is only of interest if it involves a public personality. If we nailed one of you lot, it would be front-page news. When we nailed Mr Allen and he went down for seven years with a £4 million fine, it made two lines on the middle page of the East Grinstead fortnightly *Clarion*.¹

Q11 Chairman: Let us look at some people who might be not defrauding the Revenue by making a bit of killing in this field and look at offshore accounts. This is dealt with on page 50 in paragraph 3.15. How do you deal with offshore accounts and the very large amounts of money which you are losing in offshore accounts through fraud, which is what we are discussing today, but it may also be of interest to members to hear that people are saving money by other means as well.

Sir Nicholas Montagu: Again, there have been several highly successful prosecutions. In one case an individual was sentenced to seven years and in an associated case his advisers in the UK and abroad were prosecuted. We have evidence that the publicity this case attracted did impact on the behaviour of individual tax evaders and professional advisers. The Special Compliance Office, under the leadership of John Middleton, have been successful in recovering many millions of pounds from civil fraud investigations involving offshore accounts and also, very importantly, we have made an awful lot of progress in building relationships with the Channel Islands and the Isle of Man, who now help on criminal investigations. And with money laundering legislation coming in and being extended we have access to a lot more information through the National Criminal Intelligence System (NCIS). We led the way in developing overseas information exchanges both in the European Union and the Organisation for Economic Co-operation and Development.

Q12 Mr Rendel: You said a moment ago that 6,000 self-assessment returns were chosen for random inquiry each year. What proportion is that of the whole number of self-assessment returns?

Sir Nicholas Montagu: John tells me that it is 0.1%. His mathematics are better than mine: nine million returns and just over 6,000 selected for random inquiry.

Q13 Mr Rendel: I am just interested because there are 53 Liberal Democrat MPs and at least one of us is selected for random inquiry every year. It makes me wonder whether you think we are a high risk category.

Sir Nicholas Montagu: I was wondering exactly the same thing. Every time I come to this Committee you or, now you tell me, a colleague has had a problem. Perhaps you are, but not as far as I know.

Q14 Mr Rendel: I am glad to hear it.

Sir Nicholas Montagu: I think I mentioned at my last hearing and mentioned importantly that it was with her permission I said this, that my wife was also selected for random inquiry, so it is not only Liberal Democrat MPs.

Q15 Mr Rendel: And presumably not only people who are high risk, or is your wife considered high risk?

Sir Nicholas Montagu: No; absolutely. In fact of course, to be serious about it, the essence of random inquiries is that they are just that. They are completely random, they are not risk selected.

Q16 Mr Rendel: I am glad to hear it for our sake. You were talking just now with the Chairman about publicity and saying you have tried to get publicity but the national press are very unwilling to give you any and local press sometimes do. Do you also go to specialist papers? I imagine there may be some cases where a particular type of specialist paper might be interested.

Sir Nicholas Montagu: Invariably. The specialist papers are actually among our most effective organs. They are the ones read by the tax advisers, by the people who understand the subject and publications like *Accountancy Age* are very obviously widely read by accountants; they are extremely valuable and expert in understanding.

Q17 Mr Rendel: You were not quite answering the question I meant to ask. I did not just mean specialist papers in terms of accounting papers, I also meant, for example, if you had been able to take a prosecution out against somebody in building, do you go to the building press and publicise it there? It is that sort of deterrent effect which I was looking for rather than just looking at the specialist papers.

Sir Nicholas Montagu: We certainly do. We try to make sure that if we are prosecuting in a particular sector, the trade press for that sector knows about it and publicises it.

Mr Middleton: If I might give a specific example, which is fairly typical of our approach, two or three years ago we prosecuted someone in the North West

¹ *Note by witness:* Correction, a £3.1 million confiscation order (not a £4 million fine) was imposed on Mr Allen.

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who ran a large chain of small supermarkets. When he was convicted, not only did we do the normal press notice, but we actually targeted the trade press—which is the point you are making—and got some very valuable publicity there on the back of the sentence which was handed down to him.

Q18 Mr Rendel: You were talking about the publicity which is done by some of the other departments and saying why you had not done it yourself. Are you also assessing the cost effectiveness of their advertising campaigns?

Sir Nicholas Montagu: Very much so. My own marketing and communications people, as well as the policy people, keep in very close touch with them and with all the other departments like Work and Pensions and Customs and Excise which have obvious affinities. We are actually talking to Work and Pensions at the moment about a possible campaign.

Q19 Mr Rendel: On the other hand you have been saying to the Chairman on two occasions that your Department is very different from any of these other departments.

Sir Nicholas Montagu: Yes, it is.

Q20 Mr Rendel: So how are you going to judge the cost effectiveness that would turn out from a campaign you run against the cost effectiveness of a campaign that they are running when the departments are so different?

Sir Nicholas Montagu: They are different in the respects I mentioned. Equally, there are obvious affinities between us and Work and Pensions, us and Customs. For example, if, as Work and Pensions had found, that as a result of a particularly angled publicity campaign there had been a noticeable drop in benefit fraud that they were able to correlate, then we would want to talk to them and see what lessons there were for us in countering tax fraud.

Mr Hartnett: One of the most important pieces of work for us in looking at other people's campaigns is not how successful they are in getting information, but about what the quality of that information is like. If I can give you the example of tax credits, only about 7% of the information which comes in on our hotline there is actually useful in relation to the detection of an offence. We get a lot of information, because you can receive information which says John Smith is working but he is getting a tax credit. He is supposed to be working if he is getting a working family tax credit. People do not fully understand the quality of what they are providing. That is what we really need to translate.

Q21 Mr Rendel: Are you saying that you are determined that you will go ahead with a publicity campaign, it is just that you are trying to get the right sort of publicity campaign and that is why you are reviewing what the other departments are doing?

Sir Nicholas Montagu: Yes; essentially. If talking to DWP we are persuaded that we can mount a publicity campaign which would be good value for money, we will do so. We are talking very seriously

with DWP about the possibility of a joint anti-fraud campaign. There are all sorts of other weapons: quite a lot of big accountancy firms, for example, will carry rather useful messages on their own websites warning clients that they need to come clean to the Revenue. Publicity on every front is useful.

Q22 Mr Rendel: Do you also publicise when you are running special campaigns about a particular aspect of the Inland Revenue's business, for example if you are going to run a special campaign looking at people who have offshore accounts or perhaps people who are self-employed, who are notoriously—at least according to those of us who pay PAYE—always getting away with it and the PAYE people cannot avoid the tax. Do you publicise when you are doing special campaigns of that sort?

Sir Nicholas Montagu: Yes, we do in certain ways. I can give you an example. Sir John's Report mentions the so-called leverage campaign which is a very interesting example. One obvious question is, if we mount further ones, whether we give people warning. The answer is that we will certainly want to talk through our Working Together Initiative with accountants and tax representatives about the advantages of giving advance warning.

Mr Hartnett: It depends. It depends what area we are looking at. If we are looking at the construction industry, for example, or a particular issue in the construction industry, we want people to know because people working in the construction industry are not going to disappear on us or are not going to move their assets or something like this. I should be very loath to announce publicly that we were targeting offshore bank accounts because that would be a signal for an awful lot of people to move their offshore bank account somewhere else very quickly.

Q23 Mr Rendel: If they move them onshore, that might solve your problem anyway.

Mr Hartnett: I have a feeling they might not do that.

Q24 Mr Rendel: If they move them offshore to another offshore place, then they are still in danger from the campaign.

Mr Hartnett: We have to find it, was what I really meant.

Sir Nicholas Montagu: We may see a flurry after this Committee.

Q25 Mr Rendel: Can we go on to paragraph 2.53 which refers to cases of internal fraud in which you have had problems with some of your own employees? Are the three cases mentioned the only ones?

Sir Nicholas Montagu: I can give you exact figures for internal fraud. In the last three years, from 2000-2001, we have prosecuted in successive years six, six and three people for internal fraud. As Sir John notes in the Report, the risk is pretty low. Any internal fraud is deplorable, but in a Department of 80,000 it is low.

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Q26 Mr Rendel: You say the risk is pretty low on the basis of the number of people you have prosecuted. How do you know, just because you have not prosecuted many, that the risk is low?

Sir Nicholas Montagu: We always prosecute for internal fraud is the starting point.

Q27 Mr Rendel: For internal fraud which you find.

Sir Nicholas Montagu: We have all kinds of ways of detecting internal fraud, increasingly sophisticated computer systems, management, all the usual tools. By definition I cannot say categorically yes, whenever there is internal fraud we track it down, any more than the police could say they track down all crime. What I am saying is that our techniques are pretty sophisticated and that any fraud is a fraud too many, but the evidence is that it is low.

Q28 Mr Rendel: In my experience frauds are usually things which have not happened before. It is quite difficult to commit a fraud which has happened before because then people are on the lookout for it on the whole, whereas most new frauds discovered will be things nobody has tried before. When you discover one of these frauds which have been committed internally, do you always review the rest of your system to see whether anybody else is doing exactly the same thing?

Sir Nicholas Montagu: Always.

Q29 Mr Rendel: Have you ever found any duplicate cases?

Sir Nicholas Montagu: I shall ask John to give us some detail on this because the Special Compliance Office, which he ran, also runs our investigation office. But, we do take it incredibly seriously, 95% of our staff have attended fraud awareness workshops and from 2002 to this year obviously we have done intensive training for people involved in tax credits and we do have sophisticated electronic profiling methods. We are constantly on the lookout for internal fraud. If we have evidence of a particular type of fraud, we would do a drains-up look. I remember talking with you about repayment frauds as an example.

Mr Middleton: May I come in with a specific example? We do pretty extensive profiling and two or three years ago the investigation office, which I headed up, which is our equivalent of the American internal affairs, worked in collaboration with our internal audit office in developing tools which will enable us, on the basis of investigations which we have carried out, to track down the steps people who are out to defraud us actually use in accessing our departmental computer system. We have developed means of seeing footprints on the system which lead us to frauds. We do not just do this reactively, we have run those proactively against the re-payment database to identify whether there have been any similar cases and have actually turned up one or two, but only small numbers. We have found some proactively by using these profiling tools.

Sir Nicholas Montagu: Again, I should say that whenever any member of our staff is convicted of fraud we ensure that there is full publicity in our staff newspaper.

Q30 Mr Rendel: Good. Clearly, because these people are trained to look out for fraud elsewhere and they are trained in all the rules and regulations and know what the systems are that you are using, they are themselves inevitably, without wishing in any way to insinuate that they are likely to be the sort of people who commit fraud, high risk cases because they just know more about the system so it is probably rather easier for them to find ways of committing fraud. Does that mean that you take special measures with their tax returns?

Sir Nicholas Montagu: No, we would not take special measures. Most of my people would not have to complete a tax return and most fraud, with probably one or two over the last five to ten years as glaring exceptions, is low level fraud by junior people perhaps tempted by money from a crooked debt recovery agent, or, in one case, a bigger group of criminals. These are people who would not have access to or understanding of our wider systems, who would not have a very sophisticated level of understanding of the sort you are implying.

Q31 Mr Rendel: If I may say so, what you are saying is that those are the people you have caught so far carrying out internal fraud. What I am asking is whether the people who do have to send in tax returns, which inevitably is the higher paid staff anyway, are the sort of people for whom you do take special measures to look at their tax returns particularly carefully.

Sir Nicholas Montagu: They are dealt with by a particular tax office, staffed by very expert people. I have to say, and it is something I must say I believe to be true and wish to get on the record, of course it is possible for a very clever and sophisticated tax expert in my Department to dream up sophisticated frauds. In recent years the only person who would come into that category at a senior level was the notorious Michael Allcock, on whom I had a separate hearing, and there was one other example of a low level expert a couple of years ago in a very specialised office. By definition, nobody can say there is no undetected fraud. It is a logically impossible statement to make. What I can and must say is that I am lucky in having a Department of extraordinarily dedicated and committed individuals at all levels. The reason why the Allcock case sent an absolute shudder through the Department was horror at the idea that a senior and technically trained tax inspector could betray his colleagues in that way.

Q32 Mr Rendel: I am delighted to hear that and I certainly did not want to imply that your staff are likely to be committing fraud, simply that they are high risk and clearly they need to be treated as high risk people.

Sir Nicholas Montagu: I realise that but you understand I had to say what I said.

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Q33 Mr Steinberg: Starting with the tax credit system, I have to tell you that at the moment this is the item which is biggest in my postbag.

Sir Nicholas Montagu: I am not surprised; and in mine.

Q34 Mr Steinberg: The system seems to be in chaos. Would you care to comment?

Sir Nicholas Montagu: Yes, I would care to comment. The tax credit system, as a system of credits—and I am not chopping logic—is sound, although it is not for me to comment on policy. What is happening at the moment is that the computer systems required to support the new tax credits are not working satisfactorily. I believe that we and EDS, our IT partners, did everything we possibly could to ensure that they did run satisfactorily. The Office of Government Commerce gave us a completely clean bill of health on the preparations. The system was tested extensively on what is called a clone of 50% of the capacity of the main system. For reasons which we do not fully understand, since we went to live running it has been running slowly and from time to time crashing. We are working flat out with EDS to resolve this. I got the Chairman of EDS to come over from the States to talk with me and see it at first hand last week. Meanwhile we are working as hard as we can, despite the difficulties, to get it to work. Out of 4.1 million claims to new tax credits, we have put 3.7 million into payment, and that excludes the interim payments being made through my local offices. As a result of the systems going slow and the difficulties that these have caused, the pressures on my contact centres have been almost impossible. We had planned as a contingency for up to 500,000 calls to them a week, which by any standards of any organisation was a prudent contingency. At worst we have had 1.7 million attempts to get through in a single day. It is not a system in chaos, it is a system where the computer systems to support it, which themselves represent the most complex software release ever rolled out in Europe, are not working satisfactorily. The Paymaster General has apologised to tax credit claimants for what this means. I am very happy to apologise to all your constituents and others, but I do assure the Committee that my people are working absolutely flat out and are under enormous pressures to try to get payments to people.

Q35 Mr Steinberg: I am glad you said that because I had a feeling that you were going to deny there were any problems at all and then we would have been having a little argument, a little row, would we not? At least you do accept it. Does this situation not actually encourage fraud to take place? You say it is not chaos but it seems quite chaotic to me. For example, one woman told me that she has had 12 letters, six to her husband and six to herself, giving her different reasons and different figures for her entitlement to child tax credit (CTC). If that is the case, clearly there is an atmosphere which will allow fraud to take place?

Sir Nicholas Montagu: I do not think so. That is maladministration caused by the problems I have mentioned: I make no excuse for it. Your constituent and her husband should not have had that. But, so far as people who are paid in the ordinary way through the tax credits office are concerned, we have rigorous built-in compliance and risk checks. Unlike under working families' tax credits, these are built into the system so that there is a 100% verification check, there is a 100% risk check. The systems are robust. We are now dealing with a system which depends not on a snapshot of income but on a whole year when we look back on it. The other thing of course is that people receiving interim payments through my enquiry centres are getting giros. We have talked to the Department for Work and Pensions, who have a lot of experience in this, and I am assured that there is a full giro reconciliation exercise to guard against fraud there and I have specifically asked my head of internal audit to target this as an area for scrutiny.

Q36 Mr Steinberg: Two years ago I told you about the supposed fiddles which were taking place with working families' tax credit in my constituency.

Sir Nicholas Montagu: You did indeed.

Q37 Mr Steinberg: I think you took it with a pinch of salt.

Sir Nicholas Montagu: I did not actually; may I set you right? I asked you to write to me with details and you did not.

Q38 Mr Steinberg: No, in fairness, I did not need to, if you remember. You should remember these things. You actually arranged for me to go to the Inland Revenue in Durham and I went along, so I did not need to write to you.

Sir Nicholas Montagu: Indeed, and you had a lovely day with them.

Q39 Mr Steinberg: Yes, I had a very nice day and I saw the problems they had. The point is that with this system of credits, you fill in a form and frankly you can tell lies on the form. For example, what was happening in my constituency, and if it was happening in my constituency it was happening all over the country, was that women were claiming working families' tax credits on the basis that their husbands had left them or they were no longer living with their partners. They were getting the working families' tax credit and they were either still living with their partners or the day they got it, their partners moved back in with them. Clearly they had told lies on the form and they were receiving working families' tax credits. The way you claim child tax credit is the same, is it not? You put information onto a form and that form is then accepted and you get the child tax credit. How do you check that those forms are right? How do you check that you are being told the truth? I accept when I went to Durham it was very difficult and they explained how difficult it was, but it was happening all over the country.

Sir Nicholas Montagu: I do not have any evidence that it is happening all over the country.

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Q40 Mr Steinberg: I cannot imagine they are just doing it in my constituency or were just doing it in my constituency.

Sir Nicholas Montagu: I could speculate about cause and effect if they were. Quite seriously, you are never going to eliminate tax or tax credit fraud. What we are trying to do is to build systems which are as robust as they can be, to root out fraud, to identify fraud. So, for example, we have access to a whole new range of data sources. We would do a cross check with the Department for Work and Pensions. We are now responsible for Child Benefit. The Child Benefit Centre will have data on children who are working and we can cross cut those data. We have really quite sophisticated data matching. We have built in verifiability and risk assessment and we are doing the most we can. Dave is the sponsor for tax credits and may want to add something.

Mr Hartnett: The disappearing partner trick in the world of new tax credits is not a very smart move. What we have done in new tax credits is actually built the new computer system which enables us to use our own databases and some other departmental databases to see how many adults are at a particular address. It is an automatic check in the new tax credit system, a check we run more than once a year. If someone has said on their application that they do not have a partner and our check shows that there is more than one adult at the address, we will pick that up, we will see it as a risk and if we cannot explain it from our own sources, we will challenge as we have to protect the exchequer.

Q41 Mr Steinberg: If people are paid incorrectly and they have been overpaid, how do you get it back? Do you get it back?

Mr Hartnett: We certainly shall be looking to get it back. There are several ways we can do that. We can get it back by reducing any ongoing entitlement. We will soon be able to get it back by restricting pay-as-you-earn codes and we will also get it back in appropriate circumstances by asking them for money and pursuing them through civil action if we have to.

Sir Nicholas Montagu: I have to tell you that I have just been told that we recently ordered a prosecution for living together offences in County Durham.

Q42 Chairman: One prosecution?

Sir Nicholas Montagu: So far. I do not know how rife County Durham is with these offences; only time will show.

Q43 Mr Steinberg: What are the most common scams which you have found in the tax credit system?

Sir Nicholas Montagu: New tax credits are in their infancy. Certainly so far as the working families' tax credit was concerned, the most common frauds were understated income, understated or undeclared capital, undeclared subsidiary income, undeclared partners, undeclared employment or self-employment, overstated hours, misrepresented child care, fictitious children and partners, fictitious employment.

Q44 Mr Steinberg: Are you telling this Committee that you think you can get on top of those sorts of fraud which are taking place?

Sir Nicholas Montagu: What I am saying is that we will never—no organisation will—get on top of all frauds. What we have done is to use what we have found on Working Families Tax Credit to inform the design of new tax credits, our compliance strategy and the checks which take place both within the system and outside it.

Q45 Mr Steinberg: I suspect some of the questions I want to ask are going to go into the policy area and you are not going to answer them.

Sir Nicholas Montagu: We always have this exchange, so why should we break the rule of years?

Q46 Mr Steinberg: Presumably you will tell me if I am getting out of line.

Sir Nicholas Montagu: With the greatest of respect, I shall do it, as always.

Q47 Mr Steinberg: When someone says that they probably mean exactly the opposite. I have had three cases recently, one this morning and that is the reason why I mention it. A single, unmarried mother with two babies—literally babies—who was on income support has applied for Working Families Tax Credit and is 19p a week worse off than she was before. This is certainly not in the remit of this investigation, but it seems to me that cannot be right. Is this normal?

Sir Nicholas Montagu: As you describe it, I would agree, it cannot be right. I am not of course commenting on policy.

Q48 Mr Steinberg: I phoned the Benefits Agency this morning and they say it is. They say that working families' tax credits are regarded as income and therefore are offset against income support. Is that right?

Sir Nicholas Montagu: I am not the accounting officer for income support. If you would like to write to me about the tax credits aspect of it, I shall be happy to look into it. Otherwise I am sure Sir Richard Mottram would find a letter from you as much of a delight as I always do.

Q49 Mr Steinberg: The second case is two couples; again probably not within the remit of today's hearing. I just feel you should know what is happening because clearly it is important in terms of my constituents. Couple 1 earn approximately £34,000 per annum between them and they receive approximately £42 per month in child tax credit. Couple 2 earn approximately £17,000 per annum between them and receive approximately £46 per month in child tax credit. Couple 2 both earn the minimum wage but the husband boosts his wage slightly by working overtime. Why is there such a small difference between them in terms of what they actually receive in child tax credit and why are they worse off than they were before?

Sir Nicholas Montagu: I shall come to that second point.

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Q50 Mr Steinberg: It seems to me that the system is just not working as it was designed to do.

Sir Nicholas Montagu: If it is as you describe it, that cannot be right. I do not mean you are wrong, I mean that something has gone wrong. May I ask you to write to me with details?

Q51 Mr Steinberg: I shall put all the cases to you. Yes; I shall be delighted to do that.

Sir Nicholas Montagu: You do know that we have a special help line for Members of Parliament.

Q52 Mr Steinberg: Do I know? I was in my office on Friday afternoon and I can tell you that my secretary was on the line the whole of the afternoon and did nothing else trying to sort out cases. I certainly know you have a help line.

Sir Nicholas Montagu: On your worse off point, as you describe it those two cases do not make sense.

Q53 Mr Steinberg: In three cases they are worse off with CTC.

Sir Nicholas Montagu: What I am going to say probably does not apply to any of your three cases, but I have had some correspondence from Members of Parliament whose constituents think they are worse off than they were last year. The interim children's tax credit was a tax allowance and it has been withdrawn. It was an interim measure paving the way for new tax credits and so if partner A was the earner and received the children's tax credit, he sometimes thinks he is worse off because he does not get it.

Q54 Mr Steinberg: No, I can assure you that both couples—

Sir Nicholas Montagu: It may not apply in these cases, but sometimes that is it. Even in those cases the couple is always better off. I do not know whether Dave would like to say a bit about income support and jobseeker's allowance. It sounds as though some of your constituents may be benefiting from these.

Mr Hartnett: I may just be able to clear that up for you; not numerically but by what is happening. The child tax credit premium is included in income support and jobseeker's allowance this year; before people on income support and jobseeker's allowance come across into the child tax credit in 2004. There seems to be some misunderstanding as to what happens if someone who is already getting that child premium through IS/JSA then applies to Inland Revenue for it. What happens is that because they are going to be in the Inland Revenue system looking forward the child premium will be reduced in IS/JSA because there is only one child tax credit. You get it from the Inland Revenue or you get it, if you are on IS/JSA, through IS/JSA, you cannot have both. That may explain why someone has had their IS/JSA reduced. We will have a look at that.

Q55 Mr Steinberg: This was not jobseeker's allowance it was income support. I shall certainly write. I must admit I went off the track there, but it is not often we get the opportunity to ask the man

who is responsible, is it? Coming back onto fraud, I can remember saying either to you or the Benefits Agency, I cannot remember who—

Sir Nicholas Montagu: Very different, are they not?

Q56 Mr Steinberg:—that the system was perfect for collusion between the employer and the employee and this was denied. Yet in this Report in front of us it says this is possible. What do you say about that?

Sir Nicholas Montagu: That it is possible but as Sir John noted in his last Report, there have been incredibly few examples of collusion. We have prosecuted a few, but it really is a handful. We are quite stringent in our checks and certainly when our compliance people go out and somebody was paid working families' tax credit or now when they are paid employment tax credit through the employer, they would always check that. Sir John's Report on the accounts found that collusion was not a major issue.

Q57 Mr Steinberg: I prepared four pages of questions and I have got through half a page.

Sir Nicholas Montagu: I prepared four folders of answers.

Q58 Mr Steinberg: This is because your answers are always so comprehensive.

Sir Nicholas Montagu: You are kind. So long as they are comprehensible as well, my happiness will be complete.

Q59 Chairman: I am very grateful to Mr Steinberg for getting onto the subject of tax credits which I wanted to get onto myself but time did not permit. To finish off this area, so it has some coherence with it, as I understood your answers earlier you were saying you are running a very different system to the Department for Work and Pensions but this system of tax credits is much more similar to it, is it not?

Sir Nicholas Montagu: Yes, in some ways.

Q60 Chairman: Tell us a bit about what lessons you learned from the Department for Work and Pensions and tell us also why you only prosecuted 57 tax credit frauds by December 2002 despite receiving additional resources for so doing?

Sir Nicholas Montagu: It goes back really to what I was saying earlier. Our powers are very different. We do expect that tax credit prosecutions will increase. As the Report notes, we have been given extra staff to do it. As with tax non-compliance, our primary penalty is civil recovery. I mentioned that in many cases the Benefits Agency or the Department for Work and Pensions—

Q61 Chairman: Let me stop you there. You keep saying this, but you are now distributing £5.7 billion in tax credits. Correct?

Sir Nicholas Montagu: Yes; absolutely.

Q62 Chairman: There is no point repeating to us that your powers are based on civil remedies. You are now a major player in what is effectively a social security system. Are you saying that the way you

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have been structured historically, for reasons we understand, is not allowing you to prosecute fraud in this new part of your work in the way you would like?

Sir Nicholas Montagu: No, I am not saying that at all. We have prosecuted a range of cases, from serious and organised attacks on our system to the level of opportunistic fraud.

Q63 Chairman: You prosecuted 57 tax credit frauds prior to December 2002.

Sir Nicholas Montagu: Yes; and got 56 convictions.

Q64 Chairman: You are distributing £5.7 billion in tax credits. You are not saying, are you, that you are covering the field? I cannot believe it.

Sir Nicholas Montagu: I think the inference you have drawn is not the right one. My point is that we have civil recovery powers that DWP do not have. We will prosecute criminal cases, we will take cases of serious abuse for criminal proceedings, organised fraud, fraud by our own people, this sort of thing. We have certainly learned a lot from our experience, even though you say it is limited, from prosecuting the earlier tax credits. We have recruited and started to train all our staff well in advance of this year's start. We have new production powers, we have a new criminal offence for tax credit frauds and basically we are working on a policy to enable more cases to be worked and more joint prosecutions to be taken. My point is that we can recover wrongly paid tax credits through civil process and that is an efficient way of doing it, whereas DWP do not have the same.

Q65 Chairman: Are you saying they should have similar powers? Is it not a better way of going about this?

Sir Nicholas Montagu: It is normally Mr Steinberg rather than you, Chairman, who tries to tempt me on policy. It is not for me to comment on what powers another department needs. What I am saying is that we are convinced the powers we do have make it most effective for us to proceed in this way, although, as I have indicated, we do expect to prosecute more cases. It was a relatively slow start but obviously it took time to commit the offence. We now have third party information powers and essentially we will use what we think is the best mix of criminal and civil process to deter fraud.

Q66 Geraint Davies: The statistics are that you have had 57 fraud prosecutions against expenditure of £5.7 billion, which is one prosecution per £100 million. Mr Steinberg was just saying to me as an aside that he is reasonably certain that there may be 57 fraudsters he has come across in his patch. You said at the beginning of this hearing that you had no real estimate of fraud and error and I am beginning to understand why. How big do you think this problem of fraud is?

Sir Nicholas Montagu: It is a relatively new system and we should be getting a better feel as time goes on for just how considerable the fraud problem is. I mentioned the factors we have found are most

important in determining the incidence of non-compliance and we have picked these up and played them into new tax credits.

Q67 Geraint Davies: On the disappearing partner trick, what is the penalty for that, if you do not declare a partner or a partner comes back and you get "He went off on holiday and I thought he had left me, but he hadn't and I forgot to renew the form".

Sir Nicholas Montagu: A lot would depend on the gravity of the offence, but we could prosecute, as we clearly did.

Q68 Geraint Davies: What I am asking is whether there is adequate deterrence.

Sir Nicholas Montagu: Yes; absolutely.

Q69 Geraint Davies: What sort of prosecution would you get?

Mr Hartnett: You would take a prosecution for submitting a false document to us; the penalty would depend on the courts. If someone has over-claimed credits, the penalty can be up to 100% of the credits which have been over-claimed as well as recovery of the credits and interest.²

Q70 Geraint Davies: So you pay back the credits and you would be charged the value of the credits again, something like that.

Mr Hartnett: You could be.

Q71 Geraint Davies: That might be significant or it might not be. What we have heard in this Committee already elsewhere is that there is an enormous propensity for the courts system not to recover penalties, in particular against families which are poor. I think 30% or 40% of fines in magistrates' courts are not paid. In this case we have a situation where somebody can do the disappearing partner trick, go to court and say they have no money, which is why they are on benefits. Then they just do it again, especially if you are only prosecuting 57 they have very good odds and they might just as well get on with it.

Sir Nicholas Montagu: Let me make one point. When we prosecuted 57, this was the working families' tax credit fraud. That was an interim benefit, in the way I have indicated. Working tax credits are two months old; this is a completely new system with more inbuilt risk and verification processes.

Q72 Geraint Davies: I guess what I am asking is whether you have evidence—maybe the NAO could find some evidence—or do you know in the 57 fraud prosecutions you did against tax credits, by definition poor families, how many people actually paid the fines or eventually the courts said they did not pay the fine? We know already in this Committee that 30% of people do not pay anyway.

² *Note by witness:* The reference to penalties for credits over-claimed relates to civil penalties applied by the Inland Revenue. Fines and sanctions in criminal cases are a matter for the Courts.

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Sir Nicholas Montagu: We are not responsible for following up on whether people pay their fines to the courts.

Q73 Geraint Davies: No, but I am wondering whether there is any point. Mr Steinberg is saying you should be punishing hundreds of people, but if they go to court and never pay anything there is not much point in that either. It is an open door in the system to people to defraud because they know they can just go along and defraud and they do not pay the fine.

Sir Nicholas Montagu: In a way you are sort of making my case for civil penalties, are you not? We can be very sure that we collect the penalties. We can collect over-paid tax credits from future awards and that is quite an effective deterrent.

Q74 Geraint Davies: So you are doing that now, are you?

Sir Nicholas Montagu: No, we will be. I have to go back to the point that this is a system which is two months old and which depends on a look back at yearly income.

Q75 Geraint Davies: Rather than picking on poor people shall we move on to the issue of corporate frauds and multinational companies avoiding tax to an enormous extent. To what extent do you recruit people from the biggest accountancy firms to give you advice on what advice they give to companies on repatriating profit round the world to get the lowest tax rates and to avoid you?

Sir Nicholas Montagu: Of course there is what one might describe as a wary closeness in a lot of our relationship with the senior tax advisers, but it is a genuine closeness. We have the Closer Working initiative which I have mentioned with the accountancy profession and Chartered Institute of Taxation. Dave and I and John would all see a good deal of the most senior people in the accountancy profession. You were talking about avoidance and not evasion. We must distinguish.

Q76 Geraint Davies: I appreciate that. When Andersen's started melting down because of the dodgy advice they had given to Enron, did you take the opportunity to recruit a few of these Andersen people so they could give you some advice on how to avoid tax if you are a big company?

Sir Nicholas Montagu: What we have certainly done, quite deliberately, is as more people have come free from the big accountancy firms, we have certainly taken the opportunity to recruit them, particularly within Dave's area, which is Revenue Policy and we are recruiting a lot of accountants ourselves.

Q77 Geraint Davies: Presumably they do the opposite. You say 92% of your people have these anti-fraud seminars. Presumably some of these people go along, have the anti-fraud seminars and then they go off to work for PricewaterhouseCoopers and say they know how they go about looking for fraud and they do not look here. Do you have a lot of that?

Sir Nicholas Montagu: No, we do not at all.

Q78 Geraint Davies: How do you know? Does none of your people end up working for the private sector accountancy companies giving advice on how to avoid tax?

Sir Nicholas Montagu: Of course some people go from the Revenue to the big accountancy firms. Yes, they would use their expertise as trained inspectors of taxes.

Q79 Geraint Davies: Do you recruit them the other way?

Sir Nicholas Montagu: Certainly, but we must not confuse that with fraud. When I was talking about fraud awareness, I meant fraud awareness. We were talking particularly there about internal fraud.

Q80 Geraint Davies: Can I give you a very small, not a multinational, example of a case study which I happen to know something about? There is this college called New College Cardiff which is a privately run college. It was on a site and the owner decided one day to sell this site for something like £2 million to his own offshore company, leaving a business with losses of £4 million. The company which bought it, which was his own company, then sold it for £10 million. He obviously did not pay any taxes because it was offshore. How is it that companies can do this sort of thing and what are you doing about it? Basically people are selling off assets to themselves offshore in general and then selling on the products. Do you do a lot of investigation into that sort of thing?

Sir Nicholas Montagu: We have a lot of investigations. Obviously I cannot comment on a particular case. Yes, we have a lot.

Q81 Geraint Davies: Can you look at it though?

Sir Nicholas Montagu: If you want to write to me with details, I shall look into it.

Q82 Geraint Davies: A general case. Say it is a true case and it has happened. What are you doing about that?

Sir Nicholas Montagu: The Special Compliance Office under John has recovered hundreds of millions of pounds due to us and evaded as a result of offshore arrangements.

Q83 Geraint Davies: What would you do about that?

Mr Middleton: It would be inappropriate to spill too many beans publicly on the way we do things. It would be a bit like giving the burglar the wiring diagram for your alarm system.

Q84 Geraint Davies: Say I was the person and I did this and I sold off this land and I bought it from myself offshore, made a lot of money and avoided the tax man, what could you do about that?

Mr Middleton: What I could say is that within the special compliance office, we do look at all large property transactions in UK property, involving

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offshore companies. Those are looked at very closely and where we think it is appropriate to investigate them, they will be taken up for investigation.

Q85 Geraint Davies: Is what I have just described illegal? Somebody sells some land to an offshore company which they own and then they sell it on.

Mr Hartnett: I think I can help you. If Mr X sells land in the United Kingdom to a company which is really a manifestation of himself for £1 million.

Q86 Geraint Davies: To an offshore company.

Mr Hartnett: An offshore company for £1 million, then we pick up that the property has been sold on for £10 million within a relatively short timescale, frankly £1 million to £10 million we would be interested if it were five years; that is what I mean by a relatively short timescale here. We are going to investigate that because I am afraid we are going to be incredibly suspicious that Mr X was behind the ultimate sale. That is how we operate, that is how we collect the millions Nick has talked about.

Q87 Geraint Davies: Say it is Mr X's brother or whoever it is. So I am clear, what offence has occurred. Why should he not do this? Obviously it is a scam, but have you the power to go in and take the tax which should have been paid on the legitimate price or not?

Mr Hartnett: I have to go back to where Nick was earlier on. We look to see whether it is a dishonest scam and if it is a dishonest scam, we will look for a criminal offence. If it is just an arrangement which someone has not disclosed, we will look at their tax returns and will decide again whether there is dishonesty. If there is dishonesty then we will consider prosecution as we always do when there is dishonesty. If it is some scheme that someone has been sold, it may not involve dishonesty, it may simply be a matter of avoidance. We shall still pursue it, but we will not be able to pursue it for a criminal sanction.

Q88 Geraint Davies: A basic case is a company selling its assets at below the value and saying that is all they thought they could get for them. Then they end up in another company which is somehow owned by their friends or whatever and then they set up the proper price and then they divide the proceeds. It is not very complicated. Is that illegal?

Mr Hartnett: It may be a tax offence, but it may be a civil rather than a criminal tax offence.

Q89 Geraint Davies: It seems to me that a number of those sorts of things may be happening. I was very concerned when Sir Nicholas said you did not have any estimates of total fraud and error and in fact he mentioned that national income statistics are inferred from the level of tax. I believe that it may well be the case that there is an enormous amount of tax evasion and fraud in the corporate sector, as I began to point to, as well as what others have been talking about in terms of the benefit sector. May I move briefly to the so-called shadow economy?

Sir Nicholas Montagu: Before you do, may I just say one thing equally briefly, which is that the Chancellor announced in the Budget that we were getting £66 million over three years in order to bring in £1.4 billion, the red book figure, in extra yield; and offshore avoidance and evasion is going to be a major part of the way in which we will spend that money.

Q90 Geraint Davies: Mr Hartnett said that if you chase people offshore they will go somewhere else, whatever that meant. I made a joke about buried treasure. I am not clear how keenly and how effectively we can tackle these people because obviously they have these anonymous accounts which nobody knows anything about.

Mr Hartnett: What I was saying was that there are sometimes tax offences where we are very open right from the start that we are going to pursue them. There are others, maybe where we have information about offshore bank accounts, where the last thing we want to do is to say to a group of people that we have rumbled them because we may have rumbled them in respect of one account, but we want to know whether there are more. I was saying nothing more.

Q91 Geraint Davies: I guess the general case I am making is that there is concern here about overall benefit scamming, there is concern here about the use of offshore accounts, concern about the way multinational companies arrange things and whether we have the right information from our friends in Andersen. Going on, there is concern generally about the cash economy. Clearly we have all known of situations where builders go to people and say they will do the work for cash in hand and give a low price. I have raised this question before about how often we randomly check builders, for instance. Take any situation with cash. Take Chinese Take-aways. People go in, they give cash. I am not specifically trying to say anything about Chinese Take-aways. Someone bought some chairs, sold 50 chairs in their shop, or sold 100 chairs and declared 50 chairs. It is just fraud, right? How are you going to detect that? There could be billions of pounds of lost money and you are saying there is no problem.

Sir Nicholas Montagu: Hang on, no, I am not saying there is no problem. I am saying essentially what you have been saying, which is that it is extremely difficult to estimate the size of the problem. However, you have chosen two super examples. Let me take each of them. The builder. We do not know Geraint Davies purveyor of high quality building repairs to the gentry, he is not known to us, he is what we call a ghost.

Q92 Geraint Davies: Perhaps you could use examples in your own family.

Sir Nicholas Montagu: Absolutely. Nick Montagu, provider of shelter to politicians. I am unknown to the Revenue, I am a ghost, but my risk intelligence and analysis team looks in the local Chiswick rag, sees this advertisement for Nick Montagu, purveyor of shelter, etcetera and thinks, "Hang on here".

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What I am saying dead seriously is that we have people all over the country who are extremely expert at identifying, picking up signs of people who are ghosts, whom we do not know, or moonlighters, people we know as having one job, but who have not reported the other.

Q93 Geraint Davies: I am just talking about under-declaring, like the man who takes the money at the fairground. I am not suggesting for a moment all the money they take is not declared, but it is possible that some of it might not be.

Sir Nicholas Montagu: Of course. This is where the Joint Shadow Economy Teams, which Sir John mentions in his Report, particularly come in. We particularly target cash businesses and Customs and we make use of our complementary powers and expertise to deploy our forces to best effect. John has headed our compliance outfits and might like to talk about specific techniques.

Mr Middleton: A couple of examples of the sorts of things you have described. Without giving the game away too much, if there were concerns that someone was not declaring all their income, one thing most people do is to declare the things they buy for use in the business. So the Chinese Take-away would probably declare all or most of the ingredients they buy and we could build up a figure of profit from that or look at the size of the restaurant and number of tables, do a business economics exercise. In terms of your furniture maker, look at the purchase of materials, just try to understand the business. We have a team based in Nottingham whose main job is to pull together tactical information notes for use by our people in understanding the economics of particular types of business and to pass them around investigators in the Inland Revenue so that when they come across one of these they know the things to look for and they know the questions to ask.

Q94 Mr Jenkins: Mr Middleton is right, most builders have accounts at suppliers and they go in and get their materials at a discount. If you have a builder who has a turnover with that building supplier of £30,000 in materials, and declares £30,000 a year income, you know he is on the fiddle somewhere so it is not too difficult. One of the things I was interested in, and this is a chance for you to plug some publicity, was page 42, case example I. It is where the police notified you and you found out that a rather dodgy character had been receiving income from live-in properties. You took him to court and he got three and a half years, of which one year related to working families' tax credit fraud and his wife got a community service order, which is not unusual in this world. The false claims amounted to £25,000 but nothing is mentioned in the note. I take it that you got this £25,000 back from a man of property, plus a substantial interest payment.

Mr Middleton: I do not know the specific case, but it is our normal practice when we conclude a criminal investigation to ask the court to order confiscation of the assets to recover from the person convicted of the fraud the full profit from that fraud. We are actually market leaders across all law enforcement in

this country on developing that case law. We have had a lot of notable successes in confiscation and we loaned the head of our confiscation team in the special compliance office to the new asset recovery agency to help them develop their expertise. The point I am making is that it is our general policy to ask the courts to issue a confiscation order to recover what in this case would be £25,000.³

Q95 Mr Jenkins: On the next example, J, on page 43, you do take in excess of £1 million off someone. It says "This was the first time the Revenue had successfully applied confiscation powers to the full proceeds of the crime".

Sir Nicholas Montagu: Absolutely.

Mr Middleton: Yes.

Q96 Mr Jenkins: This was two years ago.

Mr Middleton: That was a ground breaking development in confiscation law anywhere in law enforcement. The tax lost to the Exchequer was £400,000 but the person who committed the fraud had actually used that money and in effect had grown it, so the full value to that person from the fraud was £1 million. That was the amount we asked the court to seize. As far as I am aware, that had not been done anywhere before, so that was very much a first for the Inland Revenue.

Q97 Mr Jenkins: That is excellent and to be applauded and I hope you get many more of the fraudsters out there and treat them in this manner. I was listening to a programme the other day where a person had defrauded the benefit system of £20,000 and because she received a gaol sentence she thought she should not have to pay it back. We have to send a message out that we are not only going to get the money back, but if I could fiddle £100,000 and get caught and all I am going to get fined is £100,000 it is a win-win situation is it not?

Sir Nicholas Montagu: But we might get some front-page publicity if it were you, Mr Jenkins.

Q98 Mr Jenkins: No doubt you would.

Sir Nicholas Montagu: Seriously, whenever we prosecute now, we consider confiscation and when we do seek confiscation we seek confiscation of the full extent of the defendant's benefit in every case.⁴

Q99 Mr Jenkins: Excellent. These are small people. I notice in paragraph 2.50 that there is no mention of any large businesses which have been prosecuted for tax fraud in recent years. Do we have a situation in this country where large businesses now are so clean that they do not in any way consider tax fraud or have they just got better accountants?

Sir Nicholas Montagu: I think that in general—Dave and John both have longer memories than I—the businesses dealt with by my Large Business Office are reputable businesses. On the whole, what they would be dealing in is avoidance rather than evasion; sometimes very large-scale avoidance, sometimes

³ Ev 16

⁴ Ev 16

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avoidance of the sort we would regard as objectionable, because they would be what we call artificial avoidance schemes. In other words they serve no useful commercial purpose other than to find a way of getting round the intention of this House in passing the relevant Finance Act. In general it is fair to say that most large businesses in this country are reputable. I just hope I do not get out and see a placard which says “Famous last words”. This is very much Dave’s territory.

Mr Hartnett: When it comes to fraud and large business, the directors, the audit committee, the auditors are all looking out to spot that. They will chance their arm with avoidance, but the real risk with fraud is that even if we cannot find enough to prosecute big business, if you have a £10 million fraud in big business and for some reason we could not prosecute, we tried very hard, then tax on £10 million, let us say £3 million to come back, maximum penalty £3 million to come back, interest, can I have a punt at it and say £250,000? That is an awful big risk and in bigger business the controls around fraud are now really significant.

Q100 Mr Jenkins: Hence no prosecutions.

Mr Hartnett: Yes.

Q101 Mr Jenkins: Can we move on to case example K: fraudulent pension liberation schemes. I know this is a specific case, but I see on the television, when I get the chance to watch television, advertising of pension liberation schemes. I feel that if we have regulations which show that this money was put in for a specific purpose and now we have people advertising that you can take your money out of the specific purpose and maybe later on become a burden to the taxpayers, are they within the rules of the Bill?

Sir Nicholas Montagu: Yes, they are. Basically, as Sir John’s Report notes, we have killed pension busting, which is illegal liberation of pension funds. Your point about advertising is an interesting one. It is a good example. Suppose that our compliance people, let us say in Wolverhampton, noticed an advertisement for what appeared to be pension busting, they would certainly follow that up and it would undoubtedly end up with the Special Compliance Office. Basically, the word has got round. It is one of our great successes that *The Times* carried an article which effectively said “Forget pension busting”. There are schemes where money can be legally taken out.

Mr Middleton: I have seen the same adverts and as someone Nick would probably describe as “old in sin” when it comes to fraud. I have asked myself the same questions as you. The answer is that it is perfectly legal to liberate part of your pension fund, as I understand it, if you are over the age of 50 and there are tax implications in certain circumstances if you do and from what we know these people who are advertising these opportunities are perfectly legitimate. The pension busting scams that we have prosecuted were based on false documentation and they were an outright raid on the Exchequer.

Q102 Mr Jenkins: On advertising, you do not do any publicity with regard to raising awareness and changing attitudes of the public to fraud, do you?

Sir Nicholas Montagu: No, we do not. We are considering a joint campaign with Work and Pensions. We are not totally persuaded that spending money on it would be a good use of money, which is why we concentrate on the sort of things I talked about earlier, getting word around the accountants, the relevant trades and seeking publicity for convictions, particularly through local broadcasting.

Q103 Mr Jenkins: On that targeting, the steps you should be looking at and outlining with regard to individuals and traders, how are we going to get these out of the shadow economy, how are we going to bring them into the open? Do you consider things like a tax amnesty to get them from being ghosts to being real people?

Sir Nicholas Montagu: I have to tread warily here, because it is sort of policy, but I am not going to be as prissy about it as I always am with Mr Steinberg. Tax amnesties are interesting. We have thought about them in the past and we have come down against them for a number of reasons. The experience from other fiscal authorities which tried them has not actually been encouraging and it is really quite difficult to justify letting off people who have not paid their way. That said, we do behave in a sensible and pragmatic way. For example, we have done so over the Class 2 national insurance contribution penalties. If we want to bring people into the formal economy, we do not get over-bureaucratic about it. The introduction of the construction industry scheme was a good example. Lots of people came onto our books as a result of it who were not there before. If they said they had been unemployed for the last five years, we did not enquire too closely, because the big prize for us was that they were now on our books and we could see that they stayed there. That again is the importance of the right track teams who follow up in the local offices. If they do detect evasion, they will take appropriate action, but the other important point of this is that they will keep in touch with the people, help them stay on the right side and the enabling bit I mentioned earlier. The other point to mention is that if people come in out of the dark—and it is not unknown—and make a full voluntary disclosure to us, we will abate the penalties, abate according to degree of disclosure, gravity, co-operation, that sort of thing.

Q104 Mr Jenkins: Talking about coming out of the dark, these offshore accounts are rather interesting to us all. Do we know how many of our citizens have tax haven based accounts and credit card accounts? Is it possible for us to trace this sort of figure?

Mr Middleton: I do not think we do. One of the difficulties of course is that these are offshore accounts and our information powers are only effective if the information about the accounts is actually held onshore. We have made huge strides over the last three to four years in developing the

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information leads we get from places like Jersey and Guernsey and the Isle of Man. The new money laundering legislation and the development of money laundering right across the world is bringing more and more intelligence into the National Criminal Intelligence Service of money laundering disclosures which have been made to places like the regulators in Jersey and Guernsey and the special compliance office actually has staff seconded in NCIS to look for that. It is developing.

Q105 Mr Jenkins: Do these offshore accounts normally have an onshore channel to them like a bank?

Mr Middleton: No; not necessarily.

Q106 Mr Jenkins: Is it possible that banks are operating systems where they can offer offshore accounts in this country?

Mr Middleton: Probably all of the major banks in this country do.

Q107 Mr Jenkins: Do they have to tell you every single client who has an offshore account?

Mr Middleton: No.

Mr Hartnett: One of the things which is really important for our investigators to do in any case where they see something like an offshore account is to ask themselves the question: how did John Smith get to that foreign bank. If we establish that the route has been through the branch of a bank in the UK or a financial adviser or an accountant or a lawyer, we will always ask ourselves whether it is likely that that individual, that organisation has been putting others into offshore accounts. There are some examples of this in the National Audit Office Report. We always ask ourselves that question to look to see whether we can see a route to others and then endeavour to use our information powers to expose those others.

Q108 Mr Jenkins: Would it assist you if it were part of a bank's duty to inform you of every offshore account holder?

Mr Hartnett: So they would inform us of every person they knew who had an offshore or an overseas bank account?

Q109 Mr Jenkins: Yes.

Mr Hartnett: That would be a nice lot of information to conduct investigations with.

Q110 Mr Jenkins: I think that is something we may have to consider. Any difficulties in trying to put it into operation?

Mr Middleton: The banks would talk of confidentiality surrounding their honest customers, because not everyone who has an offshore account does so in order to conceal income from the tax authorities.

Mr Jenkins: There is nothing wrong with an honest person having their affairs made public.

Q111 Chairman: That will probably conclude our business. There is just one last point I should like to make. You have done a benchmarking exercise on the level and nature of fraud and working families' tax credit, have you not? Will you provide this Committee with a copy of that?

Sir Nicholas Montagu: It is not a study as such. Basically, as the Paymaster General has made clear, this is a study which we undertook to understand the effectiveness of the regime we had designed for working families' tax credit in order to prepare our systems in the way that I have indicated. We wanted to understand the effectiveness of the regime which we have designed for working families' tax credit in countering error and fraud in order to inform the design of new tax credits and the compliance strategy. It has done so in the way that I have indicated, but all that we have at the moment is the results of some analyses of cases which we have used with some other information, including tax compliance experience, to inform the design of the compliance regime.

Q112 Chairman: So you are not prepared to provide the study to the Committee?

Sir Nicholas Montagu: I do not have a report. I have data which are difficult to provide because they deal with the specifics of possible frauds. What I will take away with me is to see whether we can share details later in the year of our new tax credits compliance strategy, which will of course have been informed by the data we have received.

Q113 Chairman: Thank you very much then. That leaves me to thank you very much, Sir Nicholas, and your colleagues for coming here this afternoon. Obviously you are raising £214 billion a year in direct taxes, you are handing out £5.7 billion a year in tax credits. We will probably want to produce a report and look again at the level of information you have on fraud and compare your efforts with those of your sister departments in Work and Pensions and Customs and Excise, although we know what you said this afternoon about the differences in your Department.

Sir Nicholas Montagu: Those differences are important but I am sure that any report you produce will be of enormous value to us as always.

Chairman: Thank you very much indeed. That concludes our meeting.

Memorandum submitted by the Inland Revenue

The Comptroller and Auditor General's Report covers work we are doing to understand and measure fraud (para 1.21, 1.22 & Figure 7). The Committee may be interested in having an updated picture of the work and figures from our Self Assessment (SA) Random Enquiry Programme to help prepare for the evidence session.

This is familiar territory to the Committee. The Committee's Report, *Income Tax Self Assessment* (33rd Report, Session 2001–02) made mention of estimated sums of tax at risk from SA (Para 4 (v)). We are continuing with the SA Random Enquiry programme, and similar programmes are now under way for Corporation Tax and operation of PAYE and National Insurance by employers. Random enquiries will also play a key role in the Tax Credits compliance strategy. But for the moment, the Random Enquiry Programme for SA represents our most long-standing work in this area.

RANDOM ENQUIRY PROGRAMMES

We are undertaking our Random Enquiry programmes for three reasons. First, to have a presence throughout our customer-base, and discourage any notion of "no-go" areas. Second, because they help our research into understanding our customer population and the risks they present. We are using that knowledge to improve our risk assessment systems. And third, the programmes are designed to produce measures of the proportion of non-compliant customers. In some of the programmes, where the sample size is large enough, a usable but imprecise measure of the monetary extent of non-compliance is also produced.

There will always be constraints on the size of sample we can use to conduct the programmes. We need to be mindful of the costs both to the public, as inevitably in a Random Enquiry Programme some compliant customers will be subject to an enquiry, and to the exchequer, as there are opportunity costs involved in diverting resources away from risk-based enquiries. On our existing sample size, monetary estimates are less precise than estimates of the percentage of non-compliant taxpayers, which are accurate to plus or minus 1%. This is because monetary estimates tend to be dominated by the value of a small number of large settlements, which can make it more difficult to make a comparison from one year to the next. If we wanted to get an appreciably more precise monetary estimate, we would need to increase the sample by about a factor of four.

SA RANDOM ENQUIRY PROGRAMME

Under SA Random Enquiry, we select more than 6,000 returns for each return year. We now have results for the first three years of the Enquiry programmes, though none of these are yet final.

The estimates of tax at risk have fluctuated because some enquiries have still to be completed. As you will appreciate, Random Enquiry programmes take a long time to complete. The SA return covering 1998–99 was issued in April 1999 and was due in by 31 January 2000. From that date, there was a 12-month window, lasting until January 2001, during which we could begin an enquiry. Some cases take two or more years to settle. Additionally, a small proportion of cases are still to be completed for 1996–97 (162 out of 6,300 randomly selected) and for 1997–98 (147 out of 6,800).

The bigger, more complex cases take the longest time to settle. So in our estimates of tax lost, we attempt to make compensatory adjustments to anticipate the effect that these outstanding cases are likely to have on the overall estimate of tax at risk. As these cases are concluded and the actual results fed in, they cause our overall estimates to change. As a result, our estimate for one year has now increased, while our estimate for another year has reduced.

In more detail, for 1996–97 the estimate of tax at risk has reduced from £3 billion to £2.56 billion (+/- 16%); for 1997–98 the estimate has increased from £1.8 billion to a similar level, £2.52 billion (+/- 9%). The estimate for 1998–99 currently stands at £2.56 billion (+/- 24%).

By comparison, the proportion of fully correct returns has remained broadly the same as the original estimates, and is consistent from year to year. Within those figures we know that 70% of the tax at risk for 1998–99 is accounted for by 5% of the returns. And as we gather more data from the programmes, the accuracy of the forecast will improve.

WHAT HAVE WE LEARNED SO FAR FROM UNDERTAKING RANDOM ENQUIRY PROGRAMMES

Random enquiries are providing valuable information to enable us to develop our understanding of compliance risks and compare compliance levels across different customer groups. As part of that, we are using advanced modelling and data mining techniques on the data, to segment our customer populations and identify patterns indicating high compliance risk. These techniques have been used to select returns for enquiry.

The programmes have also raised some specific compliance issues, which will help us to target enabling activities on common issues and to target high-risk taxpayers for enquiry.

WHAT ARE WE DOING ABOUT TAX AT RISK?

It is very helpful for us to be able to identify the proportion of taxpayers whose returns are non-compliant and the level of tax at risk. We can then use that information to inform our enabling and regulating activities. We are enhancing our analytical capacity, building on existing enabling and customer support, and further developing our compliance work. I should, of course, be happy to amplify on this work at the hearing, if the Committee would find it helpful, and I look forward to our discussion.

Sir Nick Montagu
Chairman

2 June 2003

Supplementary memorandum submitted by the Inland Revenue

Questions 94–98 (Mr Jenkins):

DEVELOPING CASE LAW IN CONFISCATION

Whilst the Revenue have achieved groundbreaking extensions to legal principle in measuring the benefit of crime in relation to tax fraud, we understand that other Departments and law enforcement bodies have led the way in their own spheres of influence, notably in relation to drug-related crime. The Inland Revenue will continue, when applying for confiscation orders, to seek confiscation of the full benefit of the crime to the defendant, extending where appropriate beyond just the pecuniary advantage of the tax lost as a consequence of the fraud.

To clarify Mr Middleton's description of the case referred to by Mr Jenkins, the case involved a company director who had misappropriated £1 million of company takings, giving rise to a loss of tax. The Department, through prosecuting Counsel, argued that £1 million represented the benefit of the crime to the director and asked the Court to order confiscation of that amount. The Court concurred and ordered confiscation accordingly, even though the tax lost to the Exchequer was the lower figure of £400,000. This was an important development for the Department in our work to deprive people convicted of tax fraud of the full benefits of their crime.

23 June 2003