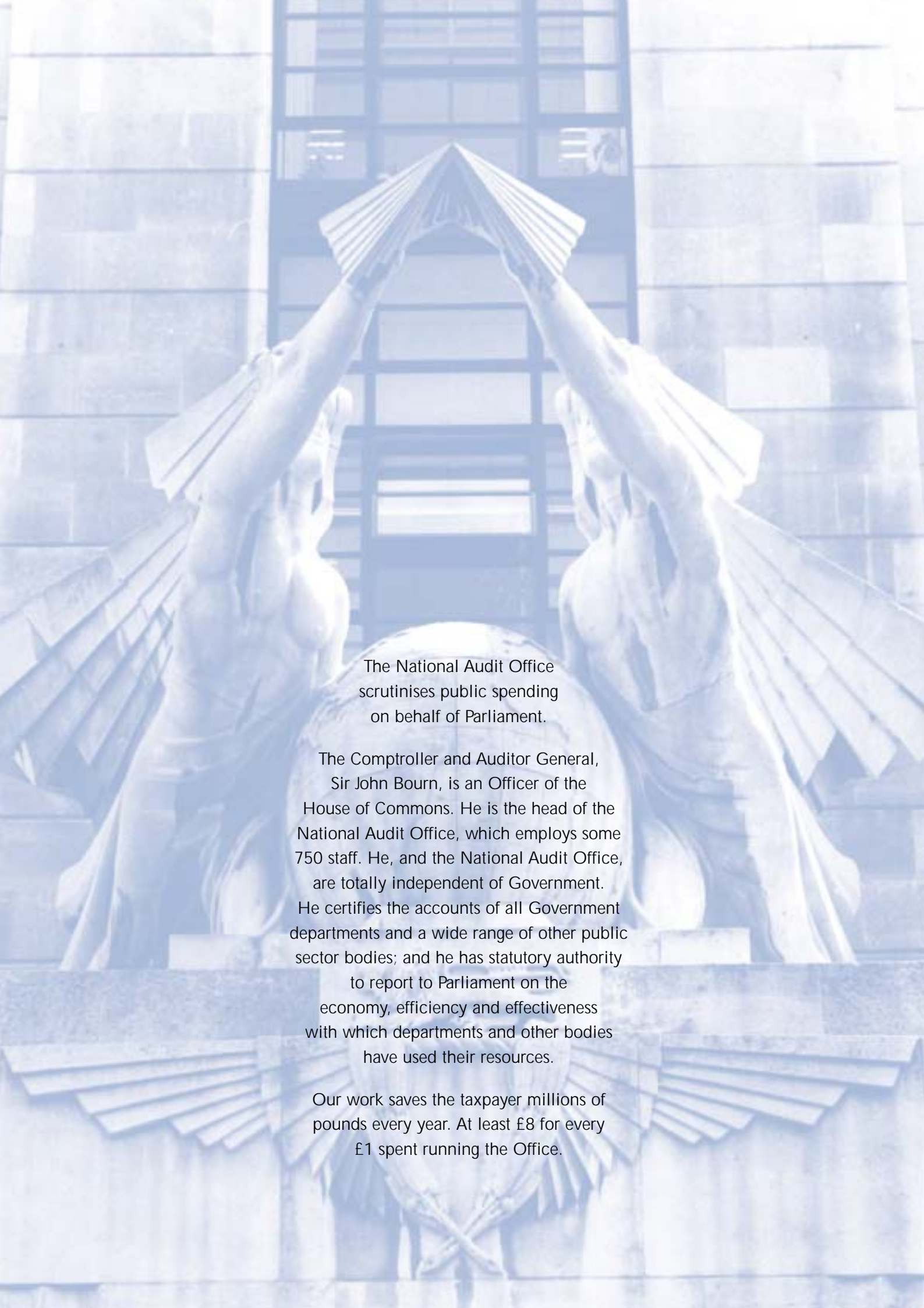


# Tackling Fraud against the Inland Revenue

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL  
HC 429 Session 2002-2003: 28 February 2003





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# Tackling Fraud against the Inland Revenue



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This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

*John Bourn* National Audit Office  
Comptroller and Auditor General 11 February 2003

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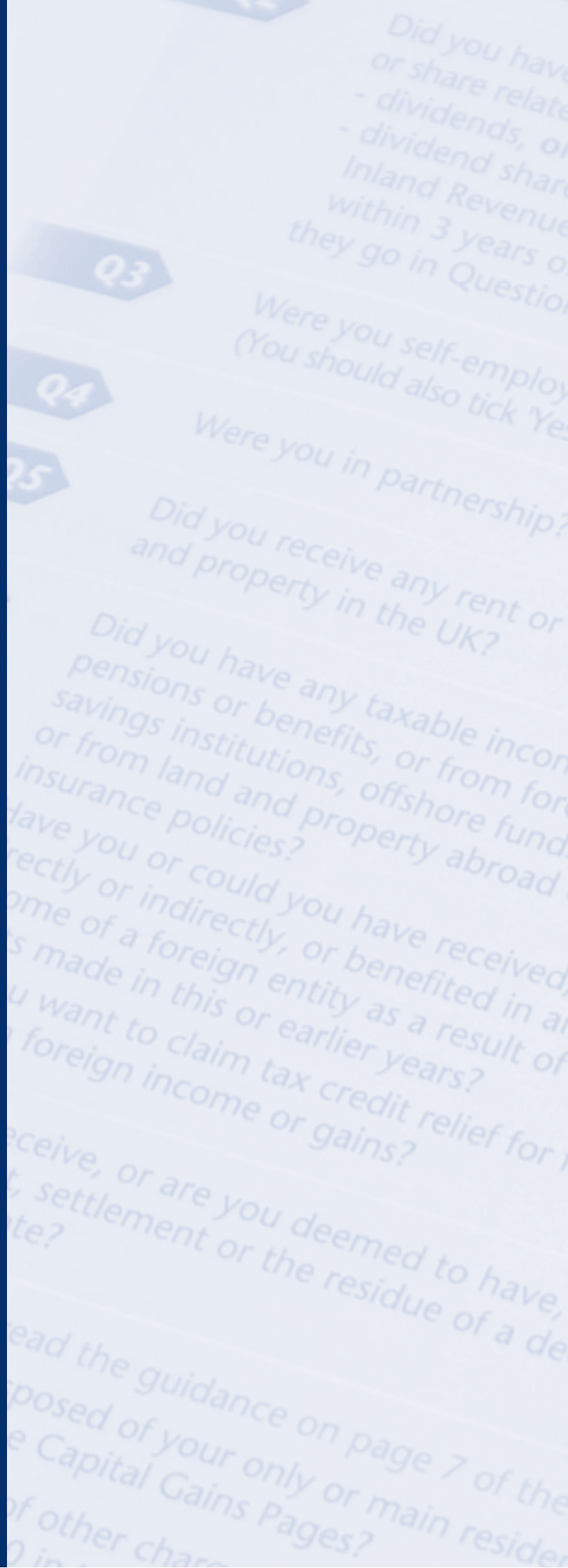
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# executive summary

## Introduction

- 1 The overall aim of Inland Revenue (the Revenue) is to maximise the compliance of taxpayers and other clients with the regulations governing tax and other areas such as tax credits. The Revenue face various risks of non-compliance including error, negligence, tax evasion and frauds. It can often be difficult to distinguish between these risks; for example, to decide whether a case involves genuine error or evasion. This report focuses on the risks of external fraud against the Revenue, which we have defined as:
  - 'tax fraud' - deliberate evasion of tax;
  - 'tax credit fraud' - deliberate claiming of tax credits to which claimants know they are not entitled.
- 2 The Revenue collect direct taxes and National Insurance contributions, £214 billion in 2001-02, representing around one half of all public revenue. Even a small percentage loss to tax fraud could amount to billions of pounds. The Revenue also face risks of fraud in tax credit payments. The Revenue made payments of £5.7 billion in Working Families' Tax Credit and Disabled Persons Tax Credit in 2001-02. The level of payment is expected to increase from April 2003 when the new Child Tax Credit and Working Tax Credit are introduced.



- 3 We have examined the work of the Revenue to counter tax and tax credit fraud, with particular reference to:
  - the challenges they face in understanding and addressing the risks of fraud;
  - the steps they take to detect and deal with fraud when identified;
  - their efforts to prevent fraud in the first place.
- 4 We examined the Revenue's work by employing specialist economic and risk management consultants to evaluate their methodologies for measuring and understanding fraud and their approach to risk management. We examined how the Revenue prevent, detect and investigate fraud in practice based on interviewing staff at headquarter and local offices and examining operational data. We consulted organisations and individuals in the public and private sector to identify examples of good practice and to determine how the Revenue's anti-fraud practices compare with and affect other organisations in the UK and abroad. Further details are set out in Appendix 1.

## Key conclusions

### Compliance strategy

- 5 While tax is generally perceived as necessary in principle by most taxpayers, attitudes to compliance vary, with some unwilling in practice to comply or co-operate with the Revenue. The Revenue first set out their compliance strategy in the mid 1980s. It has evolved since, drawing on and influencing the compliance strategies of other fiscal authorities, the key objectives being to:
- maximise compliant behaviour;
  - make it as easy as possible for individuals and businesses to claim entitlements and to comply with their obligations under the law, at the lowest possible cost to them and to the government;
  - identify and put right the conditions that lead to individuals and businesses not complying, as well as individual instances of non-compliance;
  - prevent failure and enable customer compliance as well as dealing with those who do not comply.
- 6 To encourage compliance the Revenue seek to use both traditional enforcement activities and enabling activities such as providing greater education and support to customers. They aim to balance the deployment of resources against all risks of non-compliance and to maintain a presence in all business areas, to ensure a deterrent effect and fairness to all customers. It is important that the Revenue have a clear view of the risks of external fraud and the resources and approaches they are going to use to tackle them. During 2002 the Revenue have for the first time started to develop an explicit fraud strategy as part of their wider compliance strategy, aimed at clarifying accountabilities and ensuring the risks of fraud are understood and acted upon appropriately by all operational areas.
- 7 The Revenue spent £428 million on activities such as enquiries and investigations to tackle non-compliance in 2001-02 (some 17 per cent of total Revenue costs) and achieved an overall yield to cost ratio of 8.3. The yield to cost ratio is lower than in previous years, but the Revenue expect recent compliance improvement initiatives to result in increased yield in future years. The Revenue's decisions on where to target resources are strongly influenced by retrospective comparison of the costs and yield of enforcement activities, as well as results from research into risk. To determine the appropriate level of resources and their likely effects in preventing and reducing non-compliance it is important to have robust information on losses through non-compliance. The Revenue are developing such information in relation to particular areas of the tax system, but have not found any reliable measure of the overall difference between 100 per cent compliance and actual compliance (the 'tax gap'), and the proportion of this that is explained by tax fraud. In these circumstances, it is difficult to judge the Revenue's success in tackling non-compliance and fraud.

## Measurement of fraud

- 8 It is inherently difficult to estimate the full extent of the tax gap, as there is no independent and reliable measure of the level of income or profits that should be declared and thus the level of tax due. Factors that make this difficult include determining the scale of activities in the shadow economy, the use of cash transactions, and other methods of concealment, often beyond the jurisdiction of the UK. Generating a reliable estimate of the shadow economy is problematic. There is no best estimation method. Each has its own strengths and weaknesses and yields its own insights and results. We identified recent research on the shadow economy in overseas countries, using techniques that may be applicable in the UK, to produce aggregate estimates for the lower limits of the recoverable tax gap. The Revenue acknowledge the need to obtain information on tax at risk within the shadow economy, but they consider the approaches they are developing will generate practical information on how and where tax is lost in the shadow economy that cannot be obtained from a single aggregate estimate.
- 9 In line with many overseas fiscal authorities, the Revenue have concentrated their efforts on improving their understanding of why and where tax fraud occurs, and through programmes of enquiries on random samples of tax returns, they have made progress in estimating the levels of tax at risk of non-compliance. Most progress has been made on Income Tax Self Assessment where for 1997-98 the Revenue estimated that £1.8 billion of tax was at risk of non-compliance, and potentially not collected, equivalent to 3.9 per cent of the estimated £46.3 billion from 1997-98 tax returns. In the same year 15 per cent of cases in the random enquiry programme for Income Tax Self Assessment generated additional tax yield greater than £500. These cases account for 89 per cent of the total value of tax at risk, which extrapolates to £1.6 billion or 3.5 per cent of tax from 1997-98 tax returns. A small proportion of the cases examined (3.5 per cent) resulted in the application of penalties, or referral to the Special Compliance Office for investigation (two cases), indicating a generally low level of negligence and fraud overall. The results of the 1998-99 programme are expected in February 2003, in part reflecting the time required for submission of tax returns and completion of the enquiry work and analysis. Drawing on the latest approaches being developed in measurement techniques, including those used overseas, we have recommended a number of potential improvements to existing methods for the Revenue to consider.
- 10 The Revenue have not produced estimates of the level of fraud in tax credit payments. To improve their understanding of the level and nature of the risks of error and fraud in tax credits, the Revenue are analysing a random sample of awards. The results of this work are being used to refine risk assessment and enquiry procedures for Working Families' Tax Credit and Disabled Persons Tax Credit and influence the design of compliance processes for Working Tax Credit and Child Tax Credit. Random enquiry programmes will be established for the new tax credits from 2004-05 onwards.





## Tax enquiry work

- 11 The Revenue have introduced greater prescription across the Department of the criteria used to target tax returns for enquiry by local tax offices to ensure consistent and adequate coverage in high risk sectors. The tax year 2001-02 is the first year in which new risk criteria drawing on the results of random enquiry programmes have been used to target tax returns for enquiry. It is too early to assess whether changes in the basis of selection have led to improvements in yield and detection rates.

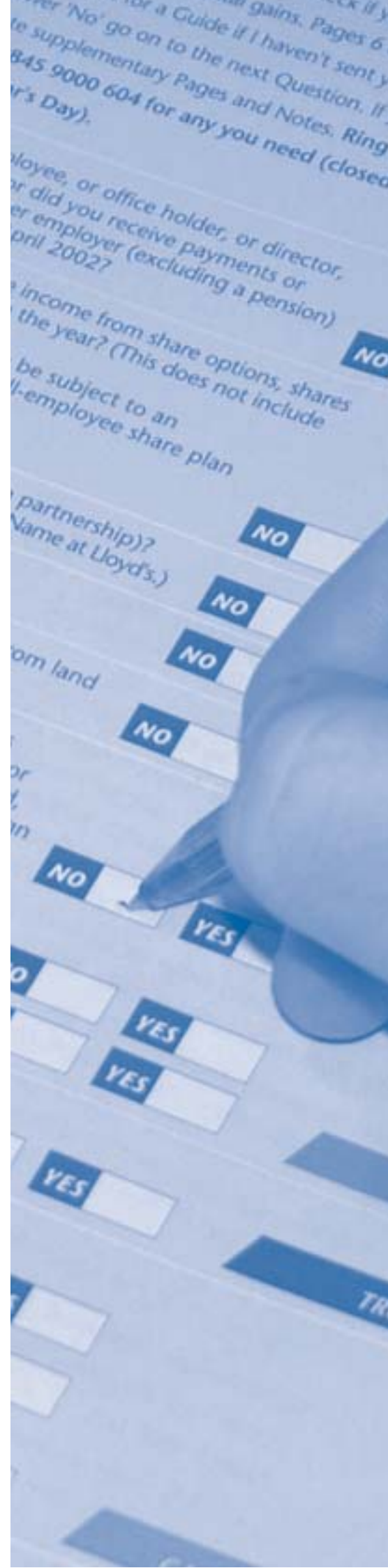
## Tackling fraud in the shadow economy

- 12 Lord Grabiner, in his report "The Informal Economy" (March 2000), commissioned by the Chancellor of the Exchequer, recognised that individuals and businesses operating in the shadow economy may be committing frauds against more than one government department. The Revenue have made good progress in implementing his recommendations to combat tax and benefit fraud. For example, the Revenue have worked closely with HM Customs and Excise, and the Department for Work and Pensions in setting up 20 Joint Shadow Economy Teams to co-ordinate action in sectors identified as areas of greater non-compliance risk. For the Revenue the initial results of this joint working are promising, indicating a potentially better average return on jointly worked cases compared with the equivalent enquiry work. The Revenue should continue to use the experience gained to identify where the joint approach maximises value, and should publicise the successes of joint working to maximise the deterrent effect and the receipt of information from the public.
- 13 In response to Lord Grabiner's recommendations, a new offence of evading Income Tax was introduced from 1 January 2001. The Revenue see this as a particularly useful means of prosecuting those involved in fraudulent activities in the shadow economy. This can involve either those who fail to declare, or under-declare, their income tax, including employers and employees who collude in committing this offence. The Revenue will be more likely to prosecute if there are further offences against other public sector regimes, in particular tax credits, National Insurance Contributions, Value Added Tax or benefits. In 2001 the Revenue received £2.0 million to recruit 42 new investigators and seven managers to conduct criminal investigations with a view to use of the new offence. As at December 2002, 21 cases were being worked towards prosecution, reflecting the time needed for the offence to come into force and to train the new investigators. Expected numbers of referrals to the new investigation teams set up to tackle the types of fraud highlighted in Lord Grabiner's report have not yet materialised. Local tax offices have needed time and assistance to understand and develop their approaches to this new type of work. Both the Revenue and the Department for Work and Pensions have taken time to work through the practical arrangements for the proper use of respective information gathering and sharing powers. The Revenue plan to identify and prosecute more cases and create the intended deterrent effect amongst those working in the shadow economy.

## Tax credit enquiry work

- 14 The Revenue have established procedures to manage the risk of non-compliance on tax credits based on both the Department for Work and Pensions' and their own experience on compliance. The implementation of non-compliance work for Tax Credits has not been without its problems as highlighted in my standard reports on the accounts of the Revenue in 2000-01 and 2001-02<sup>1</sup>. They are making progress in tackling these problems. For

<sup>1</sup> *Standard Report on the Inland Revenue Appropriation Account 2000-01 (HC 335-XVI, February 2002), and Standard Report on the Accounts of the Inland Revenue 2001-02 (published within The Department for Inland Revenue 2001-02 Accounts, HC71, December 2002).*



example, the proportion of cases where non-compliance has been detected, and the additional yield identified, has doubled between 2000-01 and 2001-02, reflecting refinements and improvements to their work on tackling non-compliance. While early results suggest detection rates will have increased again in 2002-03, it is difficult to assess the effects of this work in the absence of any overall estimate of non-compliance and fraud.

## Investigating and prosecuting serious fraud

- 15 The Revenue's Special Compliance Office has some 600 staff, of whom 301 specialist fraud investigators and their support staff are responsible for investigating serious fraud and implementing the Revenue's prosecution policy. Each year the Office complete between 400 and 450 individual fraud investigations. Between 1998-99 and 2001-02 the Office recovered £1.4 billion in tax, interest and penalties. Compared with earlier years there has been a fall overall in yield to cost ratio of the Office's activities in 2001-02. This is explained by increased costs associated with new criminal prosecution work on tax credit and 'Grabiner' work, and a reduction in overall yield explained in part by an increase in mentoring activities by investigators across other Revenue offices. The Office have been particularly innovative in researching and pursuing the leads arising out of existing investigations through projects, but the resources that can be dedicated to this valuable type of work are constrained by the need to strike the right balance between project work and completing existing investigations.
- 16 Most serious tax fraud investigations result in civil settlements requiring payment of the tax due, and in most cases financial penalties and interest. Civil investigation in cases of suspected serious fraud involves providing a taxpayer with the opportunity to fully disclose all irregularities in their tax affairs regardless of nature or size (the 'Hansard' procedure). The aim is to encourage admissions and disclosures. All cases dealt with under the 'Hansard' procedure are settled on a civil basis where a taxpayer makes a full and complete confession in response to the opportunity provided. Civil investigation of serious fraud appears very cost-effective, for example, generating around 30 per cent of the Office's £337 million additional yield in 2001-02. In 2001-02 the overall yield to cost ratio for all Special Compliance Office civil investigations, including non-fraud cases, was 20:1.
- 17 The Revenue's compliance activities need to be backed up by a robust prosecution policy that maximises deterrence and encourages full disclosure by taxpayers. The Revenue operate a selective prosecution policy designed to achieve an appropriate level of deterrence within the overall level of resources available for tackling non-compliance. Between 1998-99 to 2001-02, the Revenue's criminal prosecutions resulted in 183 defendants being convicted (a 75 per cent conviction rate). To maximise deterrence the Revenue need to ensure that a high proportion of criminal prosecutions result in guilty verdicts or pleas, while at the same time not avoiding those cases where the outcome is less certain. With a conviction rate of around 75 per cent, the Revenue appear to have struck a reasonable balance.
- 18 Criminal investigation of serious tax fraud is very resource intensive, with investigations taking two years on average to complete. The Revenue have taken action on the lessons from cases where conviction was not achieved and are looking to reduce average case times. For example, reviewing elapsed time on cases and ensuring arrangements are in place to counter claims for abuse of process stemming from delays in investigation. The Revenue concentrate on selecting for prosecution higher value, more complex and serious cases of fraud, whilst seeking coverage across different sectors and geographical areas.

To maximise deterrence across the range of their operations, the Revenue need consider, subject to resource availability, how they might increase the total number of prosecutions and extend prosecution coverage across all taxpayer groups and within lower value cases of tax evasion.

- 19 In 2000, the Revenue received £1.9 million to recruit 42 new investigators to pursue criminal prosecution work on tax credit fraud. To date relatively few prosecutions have been carried out on Working Families' Tax Credit, reflecting the time required to identify frauds and train new investigation staff. In addition, the Revenue do not have the legal basis to obtain information from third party sources such as banks, which has resulted in a number of suspected tax credit fraud cases not proceeding to criminal investigation. This will be addressed in new tax credits legislation coming into force in 2003. As at December 2002, 57 cases had been brought to court, 56 of which resulted in conviction, with a further 28 cases pending. The Special Compliance Office expect the number of cases to increase, and as at December 2002 133 investigations were ongoing.
- 20 Given the particular importance and challenging nature of their role in tackling fraud against the Revenue, the Special Compliance Office need sufficient staff with the appropriate experience. They are currently experiencing problems in maintaining a sufficiently experienced cadre of investigators, as investigators seek promotion opportunities elsewhere within the Revenue or leave to take up jobs in the private sector. The Office need to keep abreast of fraud risks as they constantly evolve. They also face a significant expansion in their workload as new areas of work come on stream. The introduction of the Money Laundering Regulations 2001, the Anti-Terrorism Crime and Security Act 2001 and the Proceeds of Crime Act 2002 are leading to increased intelligence on tax fraud and creating new roles and responsibilities for the Office. The Office are taking action to address their recruitment problems, but face a challenge in responding fully to new opportunities, continuing to develop as a major investigative unit and maintaining their quality standards.

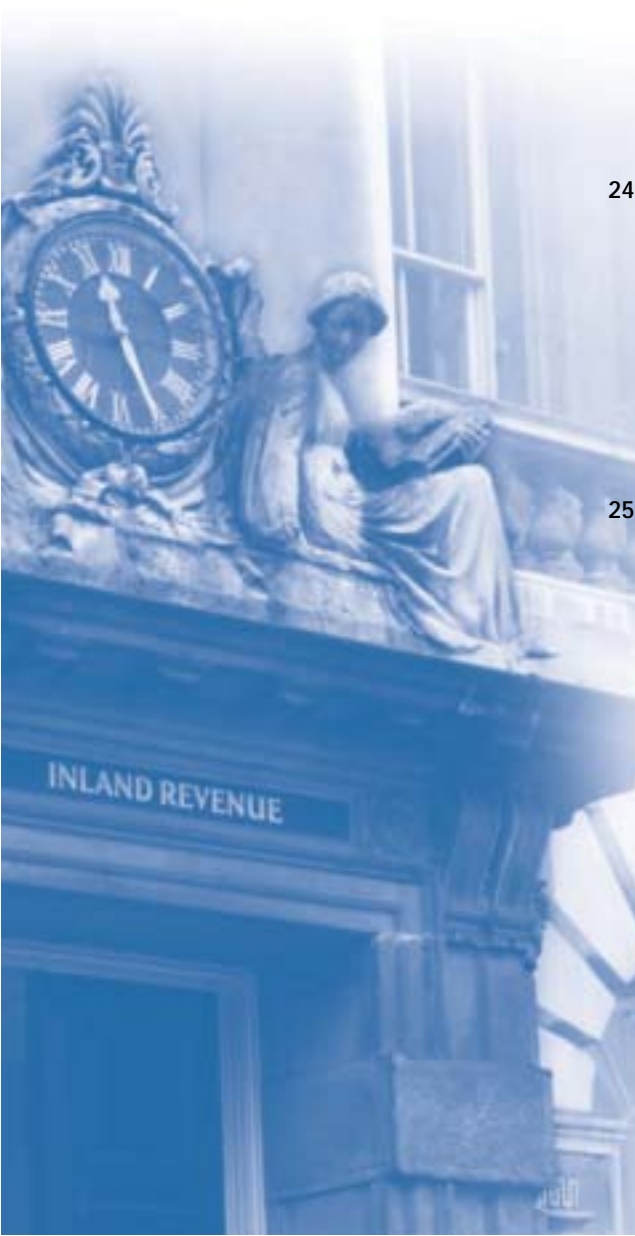
## Preventing fraud against the Revenue

- 21 The Revenue have used changes in legislation and the design of tax systems to prevent non-compliance, particularly where specific problems have occurred. The amendments in 1999 to the 'Construction Industry Scheme' are a good example of where they improved registration and increased tax deduction at source to reduce tax fraud and other non-compliance. To reduce the scope for error and to help compliant taxpayers get their returns correct, the Revenue have sought to simplify systems and introduce various educational and support initiatives allowing them to target increased resources at non-compliant taxpayer groups. For example, 'Right Track Teams' have been established to target unregistered individuals and businesses operating in the shadow economy and to help them back into, and remain in, the legitimate economy. Business Support teams have been established to provide increased support to new businesses. A number of improvements and changes are being introduced, in systems and as part of the new tax credits legislation, to address problems in tackling non-compliance and fraud experienced in Working Families' Tax Credit and Disabled Persons Tax Credit.
- 22 The Revenue have taken effective action to tackle and prevent emerging threats of tax fraud. For example, in 2000-01 the Revenue worked closely with the Occupational Pensions Regulatory Authority to improve their arrangements for sharing information and the controls over transfer of pensions between pension schemes to counter the risks associated with the fraudulent early liberation of individuals' preserved pension funds ('pension busting'). Pension busting frauds, if allowed to escalate, presented a serious threat to the tax treatment of over £1,200 billion of savings in UK approved pension fund schemes and the



well being of the schemes' intended beneficiaries in old age. The action taken by the Revenue on pension busting highlighted a number of wider lessons including the importance of effective liaison between operational areas and fraud investigators, and that the wider implications of individual fraud cases are fully considered and acted upon. Pension busting also highlights the importance of being proactive in identifying risks of fraud that may impinge on other departments, and the speed of response required to stop proliferation of new types of fraud. Building on the steps taken to tackle pension busting, the Revenue should identify the stakeholders in other key departments and ensure they maintain good contacts with them to identify, as far as possible, potential frauds at the earliest possible stage.

- 23** The Special Compliance Office consider that a major threat of serious fraud arises from the use of offshore accounts and structures. This is not a new problem, but there are increasing numbers of more complex evasion arrangements involving higher values of fraud. The Office have achieved success in tackling individual cases, but tackling the root causes and increasing the likelihood of detection have proved more challenging. In the last four years the Revenue have made significant progress in developing and improving sources of intelligence through closer working with other agencies and authorities in tax havens. Money Laundering Regulations and other legislation have opened up new sources of intelligence, and concerted international action has helped to isolate countries engaged in harmful tax practices. The Office have growing evidence that taxpayers have exploited the services offered by financial institutions to conceal funds offshore. The recent Proceeds of Crime Act 2002 establishes a criminal offence of failing to report suspicion of tax evasion designed to achieve stricter compliance with money laundering regulations. This could lead to further progress provided financial institutions and professional advisers recognise their full reporting requirements.
- 24** The Revenue recognise that increased public awareness may maximise the deterrent effect of their compliance activities including investigation and prosecution of serious fraud. They are evaluating new research into the deterrent effects of enquiry work, and into the effects of different approaches to achieving compliance with one key risk client group. They have also commissioned research into customers' attitudes to compliance. They need to consider how they might extend their evaluations of deterrence so that they are in a position to determine the relative effects of different approaches including civil settlement versus criminal prosecution.
- 25** The Revenue also recognise that more and better use needs to be made of publicity in influencing public behaviour and increasing levels of compliance and voluntary disclosure. They are currently looking at the lessons from the publicity campaigns launched by HM Customs and Excise and the Department for Work and Pensions aimed at changing peoples' attitudes to fraud. The Revenue are attempting to publicise their compliance work through periodic briefings to the media, writing articles for the professional press and through press releases on, for example, certain projects. While they have achieved good media coverage in local and specialist press, they have achieved limited national media coverage of individual criminal prosecutions, though steps are being taken to address this. They could do more to publicise specific compliance activities, including the use of publicity in advance of compliance work in specific sectors, to heighten the perception that the likelihood of detection is high and encourage voluntary disclosure.





# recommendations

## On overall strategy and risk management

- (a) The Revenue are currently developing an explicit fraud strategy aimed at clarifying accountabilities and ensuring the risks of tax fraud are fully understood and acted upon appropriately by all operational areas. It is important that the Revenue have a clear view on where the risks are, and can demonstrate that the responses and resources deployed are appropriate. We recommend that the approaches and resources for tackling known fraud risks are clearly set out along with the outcomes expected from the use of those resources (paragraph 1.17).

## On measuring fraud

- (b) The Revenue do not see estimating the shadow economy as a priority because they have not identified any reliable and practical techniques to assess the scale of unknown activity in the shadow economy and its effect on the tax gap, partly because aggregate measures will include non-taxable activity. We recognise that the Revenue, in line with other overseas fiscal authorities, are pursuing measurement techniques that provide them with practical information on how and where non-compliance is occurring in particular areas of the tax system. However, we consider there are benefits in terms of overall risk management in having an aggregate estimate of the shadow economy if a reliable and practical technique can be identified. With this in mind we recommend that the Revenue continually review new research on shadow economy measurement techniques (paragraph 1.13).
- (c) The Revenue are making good progress in developing approaches to improve their understanding of tax fraud. Paragraph 1.23 and Appendix 2 summarise detailed findings and recommendations on the approaches being used. These include:
- The random enquiry programme is designed to give estimates of the proportion of non-compliant taxpayers. It only covers registered taxpayers, however, and will not find all under-reported income. The estimates therefore understate the likely true scale of non-compliance. The US Internal Revenue Service have attempted to estimate the extent of this under-recording, and scale up the results of their taxpayer audits accordingly. The Revenue should consider whether this approach would prove useful.
  - On tax, the outcomes of random enquiry programmes are not broken down by fraud, negligence or error. Doing so may enhance the value of the information in determining the most appropriate operational response and deployment of resources. We acknowledge this would require a degree of subjective judgement about culpability in each case, and even to different facets within each case, and that UK and overseas fiscal authorities agree this is difficult in relation to tax. We recommend, however, the Revenue consider how they might break down the random enquiry results in this way.
  - On tax credits, it may be easier to determine whether each case involves error or fraud. While acknowledging the challenges involved in always being able to differentiate between error and fraud, we recommend that as the random enquiry programmes for new tax credits are implemented the Revenue consider how they might break down the results in this way.
  - The results of random enquiries, in terms of estimates of the monetary values of tax at loss are currently subject to wide margins of error. As the programme proceeds additional years data should enable reductions in margins of error. We recommend the Revenue conduct research to see if the results of targeted enquiries can be used in statistical models to reduce uncertainty in estimates of tax at risk.
- (d) The random enquiry programmes represent a major step forward in producing estimates of tax and tax credits at risk of non-compliance. If it is possible to reduce margins of errors in the results, the Revenue should, as the results of future programmes become available, use these estimates to develop performance measures and targets for reducing the monetary value of tax and tax credits at risk (paragraphs 1.23 and 1.24).

## On detecting and investigating fraud

- (e) Initial results from joint working on shadow economy cases are promising. The Revenue should seek to build on this success by (paragraphs 2.9 - 2.12):
- considering increasing the level of staff resources deployed within Joint Shadow Economy Teams along with extending Joint Team coverage where this approach maximises value;
  - developing closer links between Joint Teams and the Special Compliance Office to improve the flow of intelligence and referrals for investigation;
  - increasing referrals from external sources to the Joint Teams by publicising joint working initiatives and the mechanisms for reporting information to the departments;
  - generating more referrals to Joint Teams from within the Revenue by improving internal publicity of this new area of work.
- (f) Expected numbers of referrals to the new investigation teams set up to tackle the types of fraud highlighted in Lord Grabiner's report, have not yet materialised. Building on the progress already being made, the Revenue should ensure effective arrangements are established for 2003-04 for liaison and sharing of information between investigators, local tax offices, Risk Intelligence and Analysis Teams, Joint Shadow Economy Teams and the Department for Work and Pensions. The aim should be to increase the numbers of investigations and successful prosecutions using the new offence (paragraphs 2.15 and 2.16).
- (g) Special Compliance Office criminal investigations take two years on average, and for civil investigation of serious tax fraud the average case duration is two to three years. Close monitoring of the costs and progress of individual investigation cases is essential. The Special Compliance Office should make full use of the new management information system to plan staff usage and evaluate progress and outcomes on investigations, and seek to reduce the average time of investigations. They should ensure they differentiate between the different elements of their investigation work such as civil investigations of fraud and criminal investigations of tax fraud, 'Grabiner' work and tax credits (paragraph 2.27).
- (h) The Special Compliance Office should continue to develop their relationship with local and other specialist offices within the Revenue, building on recent developments. The aim should be to ensure all potential serious fraud cases are identified in a timely manner, a consistent and corporate approach is adopted in each case and to raise awareness about new external fraud risks (paragraphs 2.30 and 2.31).
- (i) The scope of the useful Business Anti-Fraud Hotline facility is unnecessarily restricted and we consider its value would be increased if the Hotline remit were widened to include all fraud against the Revenue and its existence publicised (paragraph 2.33).
- (j) The Special Compliance Office are increasingly becoming involved in joint counter-fraud initiatives with other agencies. They should consider the benefits of increasing the levels of joint training and secondment initiatives with others as part of a drive to further develop relationships and understanding (paragraph 2.37).
- (k) The Special Compliance Office have achieved success in securing convictions in a number of high value and complex tax fraud cases. In the context of the scale of operations and the total numbers of cases referred to the Office, the number of prosecutions ordered is low (around 50 per year since 1998-99) and mainly concentrated on higher value cases. The numbers of tax credit fraud prosecutions are increasing and a number of cases involving use of the new offence of evading income tax are working towards prosecution. The Revenue, subject to resource availability, should seek to increase the numbers of tax fraud prosecutions, including some in lower value cases, to ensure deterrence is maintained across the whole spectrum of taxpayers (paragraph 2.50).



# recommendations

- (l) The Revenue have used the powers conferred by the Criminal Justice Act 1988 since 1995, and have developed the use of legislation to confiscate in Revenue cases the full proceeds of crime rather than simply the loss to the Exchequer. In the last four years, the Revenue have sought suitable cases to build on this principle. The Revenue need to continue to build on these successes, ensuring that the good practices developed in the cases to date are fully applied in future cases and that the new opportunities afforded by the Proceeds of Crime Act 2002 are implemented quickly (paragraph 2.56).
- (m) The Special Compliance Office do not seek disqualification of company directors in all cases where they could. They should consider disqualification of company directors in all relevant cases, drawing on the approach of HM Customs and Excise (paragraph 2.57).

## On preventing fraud

- (n) The Revenue have a range of arrangements in place to encourage and assist individuals and businesses operating in the shadow economy into the legitimate economy. The Tax Faculty of the Institute of Chartered Accountants in England and Wales have suggested to the National Audit Office that the Revenue may be able to be more flexible about imposing interest on overdue tax and ensure the granting of instalment arrangements beyond twelve months was more formalised and easier to anticipate as a Revenue practice. The Revenue should consider jointly with the Tax Faculty the benefits of this suggestion (paragraph 3.8).
- (o) The action taken by the Revenue to tackle 'pension busting' highlighted a number of lessons for both the Revenue and other government departments and agencies. These lessons should be widely disseminated (paragraph 3.11).
- (p) The Revenue must continue to work closely with the banking and credit card industry, and professional representative bodies, to tackle the problems associated with offshore accounts and structures, and realise the full benefits of new reporting requirements. They should also publicise the fact that funds concealed offshore are increasingly likely to be investigated, and back this up with better publicity of the results of successful investigations and prosecutions demonstrating the severe consequences for those found guilty (paragraphs 3.18, 3.19 and 3.21).
- (q) The Revenue should extend their evaluations of the deterrent effects of compliance activities to improve their understanding of where resources may be deployed to best effect. Amongst other methods this could include monitoring recidivism rates amongst taxpayers subject to enquiry or investigation by maintaining a record of repeat offences by customers previously subject to sanction (paragraph 3.26).
- (r) On publicity, the Revenue need to reconsider their priorities on compliance and:
  - consider the benefits of launching a national publicity campaign aimed at raising awareness of the consequences of committing tax fraud both to society and individuals drawing on the lessons of other departments (paragraph 3.28);
  - drawing on the lessons learnt from the approaches of overseas fiscal authorities, be more active in publicising information on the existence of new forms of fraudulent activity and tax evasion schemes, the results of specific compliance activities and, where appropriate, plans to conduct future compliance work in specific sectors (for example, the Special Compliance Office's work on cash inducements in the hotel and catering industry) (paragraph 3.29);
  - achieve increased media coverage of successful criminal prosecution cases by, for example, linking this to wider annual publicity on the achievements of the Special Compliance Office (paragraph 3.30).

# Part 1

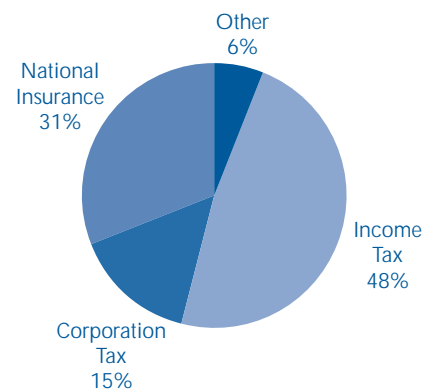
## The nature of fraud against the Inland Revenue

- 1.1 The Inland Revenue (the Revenue) face major challenges in managing the risks of fraud across their diverse operations and client base. They have not estimated the full extent of external fraud in aggregate given the inherent uncertainty involved in the assumptions that would need to be made to derive such estimates. They are, however, developing their work on estimating the extent of tax at risk of fraud by identifying the various types of fraud within different taxes and improving their understanding of where and why fraud is committed.

### The Revenue's operations and customer base

- 1.2 The Revenue manage the risks of fraud across a large and varied range of operations. On tax alone, the Revenue are responsible for collecting some £214 billion in annual direct taxes and National Insurance Contributions (**Figure 1**). Around 75,000 staff are employed to administer tax, including those in 71 area offices in seven regions across the UK and other specialist offices.
- 1.3 UK tax regulations are complex. It is a major challenge to ensure taxpayers comply with tax rules and that systems for tax collection operate efficiently, effectively and fairly. In recent years there have been significant changes in tax legislation and systems including the introduction of self assessment for income and capital gains tax in April 1996 and self assessment for corporation tax in July 1999. Tax legislation and systems are also subject to continuous change, over and above the modifications routinely introduced each year. For example, in the first six months of 2002 statutory instruments were released, introducing changes to stamp duty, inheritance tax, corporation tax, income tax, double taxation relief, capital allowances and benefits in kind.

#### 1 Inland Revenue tax and National Insurance yield in 2001-02



Source	£ billion
Income tax	103.0
Corporation tax	32.0
National insurance	65.3
Other	
Stamp duties	7.0
Capital gains tax	3.0
Inheritance tax	2.4
Petroleum revenue tax	1.3
<b>Total</b>	<b>214.0</b>

Source: Inland Revenue annual account of tax receipts and payments March 2002

- 1.4 The Revenue deal with around 30 million taxpayers ranging from large multinational corporations to individuals. **Figure 2 overleaf** divides taxpayers into eleven main groups who cover an enormous diversity of business and economic activity, all with different tax implications. Taxable activities may span international boundaries creating further complexity and requiring taxation agreements and working relations between fiscal authorities across the world. In designing systems for tax collection the Revenue have to balance the need for effective enforcement of regulation while minimising the burdens on compliant taxpayers.



## 2 Main categories of taxpayer by largest source of income 2001-02

Taxpayer Group <sup>1</sup>	Number of taxpayers	Value of tax paid (£bn)
Employed taxpayers (PAYE Income Tax - basic rate)	16,379,000	38.0
Employed taxpayers (PAYE Income Tax - higher rate)	1,978,000	36.4
Large companies (Corporation Tax) <sup>3</sup>	3,000	24.0
Small/medium-sized companies (Corporation Tax)	500,000	8.0
Self-employed (Income Tax - higher rate)	350,000	7.8
Investment income (Income Tax - higher rate)	179,000	4.9
Pensions (Income Tax - basic rate)	3,121,000	4.4
Self-employed (Income Tax - basic rate)	1,693,000	3.7
Pensions (Income Tax - higher rate)	156,000	2.1
Investment income (Income Tax - lower rate)	807,000	1.3
Employed, self employed, pensions and investment income (starting and savers rates)	3,876,000	1.1
<b>Totals</b>	<b>29,042,000</b>	<b>131.7<sup>2</sup></b>

### NOTES

1. Taxpayers are categorised by Taxpayer Group dependent on their single highest individual source of income. The table does not indicate the true volume of business, as in reality many taxpayers are dealt with in more than one capacity within the tax system. For example a higher rate PAYE taxpayer will be paying National Insurance Contributions and could have investment and pension income with additional tax liability.
2. Excludes one off tax payments such as capital gains, inheritance tax and stamp duty.
3. Companies with a net Corporation Tax Liability of £1 million or more.

Source: *Inland Revenue Analysis and Research Division*

### 1.5 The Revenue's operations continue to expand beyond mainstream tax responsibilities:

- In October 1999 the Revenue assumed responsibility for payment of Working Families' Tax Credit and Disabled Persons Tax Credit. The Revenue now employ around 3,400 staff in their Tax Credit Office, and in 2001-02 some £5.7 billion was paid to 1.3 million claimants.
- From April 2003, Children's, Working Families and Disabled Person's Tax Credits will be abolished and replaced by the new Child Tax Credit and Working Tax Credit. The Child Tax Credit is for families and lone parents with at least one child, while the Working Tax Credit is for those in paid work. The amount paid will depend on the claimants' income and the number of hours worked. Annual expenditure on all tax credits is forecast to exceed £15 billion by 2003-04.
- In April 2000, following the transfer of the Contribution's Agency to the Revenue, they assumed overall responsibility for the administration of National Insurance Contributions. This has entailed the rationalisation of the Revenue's approach to

employer compliance bringing together work on National Insurance Contributions, Pay As You Earn and Tax Credits.

- In recent years the Revenue have also taken on responsibility for monitoring the law relating to the National Minimum Wage, collecting Student Loan repayments, and a range of statutory payments made by employers including Statutory Sick Pay and Statutory Maternity Pay.
  - In April 2003 the Revenue assume responsibility for the administration of Child Benefit from the Department for Work and Pensions.
- 1.6 Against a background of diverse operations, the Revenue face a number of risks of non-compliance of which fraud is only one:
- Clients can make genuine errors or fail to take account of all relevant information in submitting their return or misunderstand tax regulations. In some cases errors may arise through negligence. Negligence is defined in legislation and case law as failure to take reasonable care to, for example, give notice, make a return or furnish a document or information required under tax legislation.

- Tax evasion encompasses the making of a deliberately fraudulent return to a deliberate failure to make a return or pay tax at the proper time. Differentiating evasion from negligence will depend on determining the degree of culpability and the intention of the taxpayer. While acknowledging that there is not always a clear dividing line between negligence and evasion, for the purposes of this report we have defined tax fraud as deliberate evasion of tax. The Revenue also face fraud in tax credits where the same difficulties in distinguishing between fraud and negligence also exist, but where we have defined fraud as applicants deliberately claiming tax credits to which they are not entitled.
- Investigation into avoidance may reveal activities that are susceptible to challenge under existing law, in particular where a transaction has not been carried through properly. Significant risks to tax are involved but avoidance is not the subject of this report.

## The range of frauds committed against the Revenue

1.7 Tax fraud is the main threat of external fraud faced by the Revenue. It can be opportunistic, for example, a self-employed trader putting cash into his or her back pocket and knowingly under-reporting sales. It can be systematic and premeditated involving deliberate concealment of very substantial amounts of income from the Revenue and involving conspiracy on the part of people in positions of responsibility such as company directors and their professional advisers. The Revenue have limited evidence of the involvement of organised gangs in systematic tax fraud, though cases do occasionally occur linking tax frauds with individuals involved in wider criminal activity. Cases involving fraud or collusion by members of the Revenue's staff are rare. Different types of tax fraud often exhibit common features and are committed using common methods (Figure 3).

### 3 Common types of tax fraud

Type of fraud	Main features	Common methods
Extractive	Reduction in profits by concealing business activity (diverting income, inflating purchases or deflating sales)	<ul style="list-style-type: none"> <li>Misdescribing expenditure</li> <li>Use of diverted cash to buy goods</li> <li>False invoicing</li> <li>Removal of invoices</li> <li>Invoice routing (for example, across national borders)</li> <li>Transfers to offshore accounts and structures to conceal ownership</li> </ul>
Non-extractive	Post-event manipulation of accounts to reduce profit	<ul style="list-style-type: none"> <li>Manipulation of creditor/debtor position</li> <li>Understating stock</li> <li>False use of accounting provisions</li> </ul>
Other	<ul style="list-style-type: none"> <li>Undeclared economic activity and income</li> <li>Pay as You Earn/National Insurance offences (Case example A)</li> <li>Non-eligibility for allowances/deductions</li> <li>Non or false disclosure of benefits</li> <li>Sub-contractor frauds</li> <li>'Phoenixism'</li> </ul>	<ul style="list-style-type: none"> <li>Individuals and businesses not registered for tax and unknown to the Revenue ('ghosts')</li> <li>Employees registered for tax who also work on the side, usually for cash ('moonlighters')</li> <li>Use of diverted cash to pay top up wages</li> <li>Falsification of return</li> <li>Falsification of claims</li> <li>Falsification of return</li> <li>Use of diverted cash to pay cash top-ups to sub-contractors</li> <li>Theft or false use of exemption certificates</li> <li>Contrived liquidations to evade tax liabilities</li> </ul>

Source: National Audit Office

## CASE EXAMPLE A

### Pay as You Earn and National Insurance Contribution fraud

Over a period of several years, a husband and wife who ran a courier/delivery business, operated Pay As You Earn on the wages of their employees. However, they failed to send in returns of tax and National Insurance Contributions deducted or pay over the appropriate amounts to the Revenue. They also made payments in cash to certain employees for overtime and Saturday working, and had paid casual employees cash in hand, without including them with the wages taxed under the Pay As You Earn scheme.

The case was taken over from the Contributions Agency following its merger with the Revenue, with additional Revenue issues being added to the continuing criminal investigation. Tax losses were determined in excess of £150,000. The wife pleaded guilty to the charge of cheating the Revenue contrary to common law, while the husband was found guilty of the same charge at a subsequent trial. The wife was sentenced to three months in jail and the husband to one year. As there were no known assets, compensation and penalties were not sought.

*Source: Special Compliance Office*

## CASE EXAMPLE B

### Fraudulent tax avoidance scheme

A foreign national, who was marketing similar schemes in his home country, devised a tax avoidance scheme in the UK enabling companies to buy into a series of container leasing and sub-leasing arrangements. The companies involved in the scheme would be able to claim capital allowances on the underlying container assets and reduce profits chargeable to corporation tax. A total of 31 UK close companies entered the scheme, which if successful, would enable them to avoid around £100 million in taxes. Revenue investigations, including close liaison with overseas counterparts, revealed the alleged avoidance scheme was fraudulent as the leased assets were only owned by companies operating the genuine trade in container leasing and not the companies in the scheme.

The overseas fiscal authorities regarded the arrangements in their country as an economic crime against the state. They arrested the scheme deviser and eventually he was in 1999 sentenced to seven years imprisonment in his home country. The UK scheme was stopped at a point where £34 million in corporation tax was estimated at risk. At interview, directors from the UK companies were able to prove they had carried out due diligence before getting involved in the scheme, including advice from their accountants and solicitors and opinions from Tax Counsel confirming the scheme worked on technical grounds. None of the companies had any previous history of tax problems. In these circumstances the Revenue accepted the companies were not culpable and settlements were based on recovery of £34 million in tax and £3 million in interest. Several of the companies took subsequent action against their advisers on the grounds they had been misled and defrauded.

*Source: Special Compliance Office*

- 1.8 Alleged tax avoidance schemes may sometimes conceal or stray into tax fraud and other forms of fraudulent activity. Such cases tend to be highly organised, involve high values of tax at risk and reflect differing degrees of novelty and complexity. Even where schemes appear legal, steps may not have been followed properly or at all, rendering the attempt to avoid tax illegal, and possibly fraudulent. For example, in some cases the scheme arranger may fraudulently 'back fit' a genuine business or financial activity into an avoidance scheme (**Case example B**).
- 1.9 On tax credits the Revenue's experience to date indicates that frauds tend to be low value opportunistic attempts by individuals to claim credits to which they are not entitled. More recently evidence has emerged in one case potentially linking an organised gang with use of multiple fictitious identities to obtain tax credits. Tax credit fraud risks include:
- individuals failing to declare to the Revenue that they are working below the minimum hours required or below the minimum earnings threshold, or that another member of the household is working;

- collusion on the part of employers and employees where employees work less than the required number of hours, do not receive the minimum level of payment, or are paid undeclared cash top-ups.

- 1.10 Like other departments issuing and receiving cheques the Revenue are at risk of instrument of payment fraud where cheques are intercepted and fraudulently altered and encashed. Repayments of tax and direct payments to tax credit recipients are the key risk areas. This type of fraud can be opportunistic or highly organised. There have been a small number of cases where instrument of payment fraud has involved external parties acting in collusion with Revenue staff. In the context of the numbers of payments handled by the Revenue, however, this risk is very low.

## The scale of fraud against the Revenue

1.11 In the absence of any measure of the difference between 100 per cent compliance and actual compliance (the 'tax gap'), and the proportion of this that is explained by tax fraud, it is difficult to judge the Revenue's success in tackling non-compliance and fraud. The tax gap will include revenue lost through all forms of taxpayer non-compliance. The Revenue, however, consider it unrealistic to establish a meaningful single aggregate estimate of the tax gap because:

- no independent baseline exists to assess the level of income or profits that should be declared and the level of tax due;
- there are no known reliable and practical methods to assess the scale of unknown activity within the shadow economy and its effect on the tax gap;
- there are no known reliable and practical methods to assess the scale of income and assets concealed by known taxpayers.

1.12 The shadow economy is economic activity that results in transactions comprising payment or other benefits that are not declared to public authorities. Such activity may not be illegal, or it may not have tax implications. However, it is likely that significant tax fraud exists. The Revenue have not produced any aggregate estimates of the size of the shadow economy. They consider it would require considerable time and resources and yield limited information about the size of the tax gap and levels of tax fraud, and in itself tell them little about where and how to deploy resources to tackle non-compliance. They also consider that it would never be cost-effective to tackle all non-compliance that might exist in the shadow economy. From their own reviews the Revenue have concluded, most recently in 1997, that the methods used by academics and others to estimate the UK shadow economy contain questionable assumptions, or produce estimates with such wide error margins as to be of limited value. The Revenue keep this under review.

1.13 We examined the most recent approaches to measurement of the shadow economy and the tax gap by academics and other fiscal authorities, and the conclusions they have been able to draw about tax fraud (Appendix 2). There is wide agreement about the value in attempting to obtain information on tax at risk within

the shadow economy, as well as on who is committing the evasion and where it is occurring. Such information is valuable in informing estimates on the level of recoverable tax, and improving decisions on resource allocation and understanding of the effects of activities to tackle non-compliance. We confirmed the Revenue's view that there is no best estimation method. Each has its own strengths and weaknesses and yields its own insights and results. We did, however, identify recent research on the shadow economy in New Zealand and Canada using techniques that provided an aggregate estimate of the lower limits for the recoverable tax gap that might have practical application in the UK. The Revenue, however, consider the approaches they are developing will provide practical information on the nature and location of activities in the shadow economy that cannot be obtained from a single aggregate estimate of the shadow economy (paragraphs 1.21 to 1.24). We found other fiscal authorities share the Revenue's view, as reflected in the similar approaches to measurement they are developing.

1.14 In terms of estimating the level of tax fraud being committed by known individuals and businesses the Revenue consider there are two main problem areas:

- The use of cash transactions to evade tax is a particular threat. This is a well-known and relatively easy way to conceal, albeit often low value, activities from the Revenue. Information gathering powers are of little value in these circumstances because audit trails will not exist. Whilst it is possible to identify high-risk areas, and in detected cases determine the level of inconsistency in business records and the value of concealed cash transactions, overall estimates would be subject to such a degree of uncertainty as to be of little value.
- At the more serious end of the tax fraud spectrum, the use of offshore accounts and structures to evade tax creates similar uncertainties. Again, while individual cases come to light, often involving large sums, it is difficult for the Revenue to produce meaningful estimates of the levels of taxable income and assets concealed in this manner as records lie outside the Revenue's jurisdiction.

The action taken by the Revenue to detect, investigate and prevent fraud in the shadow economy, or involving use of cash transactions or offshore accounts and structures is examined in Parts 2 and 3.



## The Revenue's approach to compliance

1.15 The Revenue's compliance strategy was first set out in the mid-1980s and has been evolving ever since, drawing on and influencing the compliance strategies adopted by other fiscal authorities. The Revenue play an active role in the Organisation for Economic Co-operation and Development Forum on Tax Administration and is a steering group member, along with the USA, Canada, Australia, Japan, France and Germany. They liaise closely with counterparts in these countries and other European Union members. The current compliance strategy is informed by the experience of:

- the US Internal Revenue Service focus on enabling taxpayers to comply with their tax obligations voluntarily and with greater ease;
- the Australian Tax Office focus on understanding the risks of non-compliance and encouraging voluntary compliance through influencing attitudes and behaviour of taxpayers.

1.16 The Revenue seek to use both traditional enforcement activities and enabling activities such as providing greater education and support to customers (Figure 4). Through increased emphasis on actively managing customer relationships, they aim to increase compliance, and free resources to tackle higher risk areas and cases of detected non-compliance.

1.17 It is important that the Revenue have a clear view of the risks of external fraud and the resources and approaches they are going to use to tackle them. During 2002 the Revenue appointed the Director of the Special Compliance Office as their 'fraud champion' with responsibility for developing an explicit tax fraud strategy aimed at clarifying accountabilities and ensuring the risks of tax fraud are fully understood and acted upon appropriately by all operational areas.

### 4 The main elements of the Revenue's current compliance strategy

#### Enabling compliance

- Make it as easy as possible for individuals and businesses to claim entitlements and comply with their legal obligations, at the lowest possible cost to them and to the government
- Identify and put right the conditions that lead to individuals and businesses not complying
- Emphasis on preventing failure and promoting customer compliance
- Consider extent to which the Revenue have contributed to failures by customers and where new procedures, targeting and marketing would help
- Recognise when and where contacts contribute to improvements in customer perceptions, take up of entitlements and increased customer compliance
- Encourage a positive attitude towards the funding of public services through taxes and contributions
- Develop measures that focus on compliance and the extent to which entitlements are taken up
- Contribute to the government's policies by fostering an environment for business to flourish by:
  - moving individuals from the shadow economy
  - reducing the burden of regulation to give UK business a competitive edge

#### Enforcing compliance

- Maximise compliant behaviour by dealing appropriately with businesses and individuals who do not comply
- Combat fraud.

*Source: Inland Revenue Business Direction (January 2000)*

1.18 The Revenue have a Public Service Agreement target to deliver year on year improvements in the numbers of individuals and businesses complying with their obligations and receiving their entitlements. Performance is assessed in terms of the numbers of returns being filed on time, the percentage of customers who submit accurate returns and the proportions of returns where checks are completed to a full satisfactory standard or non-compliance detected. Performance in terms of additional yield and detection rates is covered in part 2 of the report.

1.19 The Revenue seek to deploy available resources to secure coverage against all risks of non-compliance and maintain a presence in all business areas, to ensure a deterrent effect and fairness to all customers. While not targeting additional yield, their resource deployment decisions are influenced by retrospective comparison of

the costs and yield of compliance activities, particularly in the traditional tax gathering areas of their business. In some areas, notably prosecutions, other factors such as the likelihood of conviction and the related deterrence impact are of greater importance than additional yield to the Revenue. The annual cost of the work such as enquires and investigations in tackling non-compliance represents around 17 to 19 per cent of the Revenue's total administrative costs<sup>2</sup> (just over £2.5 billion in 2001-02), and generates a return of between 8 to 12 times the cost (Figure 5). The Specialist Offices generate the highest additional yield, the single largest contributor being the Large Business Office (around 40 per cent of total Specialist Office additional yield in 2001-02), where yield is largely generated by the examination and legal challenge of large companies' tax planning and avoidance activities.

## 5 Cost benefit of Revenue work to tackle non-compliance

Year	Cost of activities to tackle non-compliance <sup>1</sup> (£ million)	Additional yield (£ billion)	Yield: cost ratio <sup>2</sup>
<b>2001-02</b>			
Local tax offices	£355	£1.3	3.6
Specialist Offices <sup>3</sup>	£73	£2.3	30.8
<b>Total</b>	<b>£428</b>	<b>£3.6</b>	<b>8.3</b>
<b>2000-01</b>			
Local tax offices	£380	£1.2	3.3
Specialist Offices <sup>3</sup>	£75	£3.0	40.0
<b>Total</b>	<b>£455</b>	<b>£4.2</b>	<b>9.3</b>
<b>1999-00</b>			
Local tax offices	£376	£1.4	3.6
Specialist Offices <sup>3</sup>	£70	£3.8	55.0
<b>Total</b>	<b>£446<sup>4</sup></b>	<b>£5.2<sup>5</sup></b>	<b>11.7</b>
<b>1998-99</b>			
Local tax offices	£307	£1.0	3.2
Specialist offices <sup>3</sup>	£72	£2.8	39.1
<b>Total</b>	<b>£379</b>	<b>£3.8</b>	<b>10.0</b>

### NOTES

1. Compliance costs include salaries, accommodation and direct operating overheads.
2. Does not take account of deterrence effects or future savings.
3. Does not include yield from compliance activities in Capital Taxes Office, Stamps Office and other smaller specialist compliance offices. The aggregate from these offices is low in comparison to total yield and will not materially affect the overall yield to cost ratio. Additional yield from these offices was: 1998-99 £214 million; 1999-00 £231 million; 2000-01 £253 million; 2001-02 £267 million.
4. Increased costs in 1999-00 reflect mainly the effect of the increase in enquiry work on Self Assessment Income Tax, plus the additional 8,400 staff joining the Revenue following the merger with the Contributions Agency.
5. The increase in yield in 1999-00 is explained by some exceptionally large settlements by International and Oil Taxation Office. In general, additional yield can vary from year to year. For example, conclusion of a large case or closure of a widespread avoidance scheme can result in increased yield in that year.

Source: Inland Revenue and National Audit Office estimates of overall costs and yield

<sup>2</sup> Other administrative costs are incurred on processing tax returns, administering National Insurance Contributions, rating and council tax plus other property valuation services, policy analysis and dealing with customer enquiries.

1.20 In light of the difficulties in determining the overall level of tax fraud, the Revenue are concentrating on understanding better how tax is evaded in particular areas of the tax system. This includes identifying taxpayer groups where there is high risk of non-compliance, the reasons for their behaviour, and implementing appropriate operational responses. Much of this work is at an early stage of development (Figure 6), though it builds on various earlier work by the Revenue in particular areas of the tax system. Where applicable, measurement techniques are being used in targeted areas, for example, the random enquiry programmes, with different approaches being used dependent on the taxpayer or customer group under consideration.

1.21 The techniques in which the Revenue place most confidence are the random enquiry programmes. With the introduction of Income Tax Self Assessment the Revenue obtained for the first time the power to

undertake random enquiries into tax returns. Previously they had to have good reason to initiate an enquiry so they were not able to randomly sample returns and generate results capable of extrapolation. The results of their first random enquiry programmes on Income Tax Self Assessment for the 1996-97 and 1997-98 tax years became available in 2001. The two programmes showed that around one third of taxpayers were non-compliant, but that there were wide differences in the estimates of tax at risk of non-compliance<sup>3</sup>:

- £3.0 billion for 1996-97 tax returns (6.8 per cent of the estimated 44.1 billion that should have resulted from the 1996-97 tax returns);
- £1.8 billion for 1997-98 tax returns (3.9 per cent of the estimated £46.3 billion that should have resulted from the 1997-98 tax returns). The Revenue believe that the higher figures for 1996-97 may be due to this being a transitional year.



<sup>3</sup> Estimates are based on tax returns actually received, and do not include tax which relates to people who should have sent in returns but have not done so. Percentage calculated as  $a/a+b$  where:  $a$  = tax identified at risk from random enquiry; and  $b$  = total estimated Income Tax and National Insurance Contribution liability for Self Assessment taxpayers, including tax deducted at source

## 6 The Revenue's approaches to measuring and understanding tax fraud

Taxpayer or customer group	Approaches being used or developed	Results and response
Individuals and businesses operating in the shadow economy	<p>Comparing expected income levels derived from the Labour Force Survey with information reported to the Revenue on the assumption that people will respond more honestly to the former. This should provide a better understanding of:</p> <ul style="list-style-type: none"> <li>■ the location of tax evaders by sector;</li> <li>■ the level of the unknown population (ghosts and moonlighters)</li> </ul> <p>Compare the results of the above with information held by the Department for Work and Pensions.</p> <p>Risk and intelligence work in local tax offices.</p>	At a developmental stage with data sharing arrangements remaining a significant issue to resolve.
Income Tax Self Assessment (individual taxpayers and small and medium sized companies)	<p>Since obtaining the statutory power to conduct random enquiries in 1997, the development of random enquiry programmes involving selection of around one in every thousand tax returns which local staff must subject to a full enquiry. Measures of under-reporting for the self-employed are checked against further econometric modelling using the Family Expenditure Survey to validate and clarify the results.</p> <p>Analytic techniques such as cluster analysis, regression and rule induction are being used to get a better understanding of non-compliance and to identify risk areas.</p>	<p>Results of data mining used to inform the centrally driven selection of targeted enquiry programme in 2001-02.</p> <p>Results of the 1998-99 programme expected in February 2003.</p> <p>Quantitative research commissioned in 2001 to explore new ways to understand attitudes amongst key risk groups and how to encourage compliance within them. Results expected by end 2002.</p>
Corporation Tax Self Assessment (small and medium sized companies).	Random enquiry programme from 1998-99.	Results expected in 2004
Corporation Tax Self Assessment (large businesses)	Comparison of tax payments with reported profits from externally available account data. Comparisons of like companies to explore variations in tax payments.	At an early developmental stage, but results will be used in targeting areas for detailed enquiry work on large businesses.
Employer compliance (Pay As You Earn, National Insurance Contributions, Tax Credits)	Random enquiry programmes began in 1999.	Results to be confirmed in early 2003.
Working Families' Tax Credit	A one-off benchmarking exercise entailing random selection of recipients for review followed by full enquiry where non-compliance suspected.	Analysis of the results is underway. It is likely that further work is required to complete this exercise.
New Tax Credits	Legislation introducing New Tax Credits provides full random enquiry powers. A random enquiry programme will be conducted for New Tax Credits following their introduction in April 2003.	The first year of the random enquiry programme will be 2004-05, with the first results expected after the year-end. The Revenue will not be able to establish a baseline for improved performance until after the full population for Child Tax Credit is identified by the end of 2005-06.

### NOTE

There is a significant time lag between the year selected for random enquiry and the emergence of results, given the time required for submission of tax returns and completion of the enquiry work and analysis. Emerging results are fed into future work programmes where appropriate.

Source: National Audit Office



1.22 A small proportion of taxpayers were responsible for the majority of the value of tax at risk. In 1997-98 the 15 per cent of cases generating additional tax yield greater than £500 (Figure 7), accounted for 89 per cent of the total tax at risk (£1.6 billion or 3.5 per cent of tax that should have resulted from 1997-98 tax returns). A small proportion of the cases examined (3.5 per cent) resulted in the application of penalties, or referral to the Special Compliance Office for investigation (two cases), indicating a generally low level of negligence and fraud overall. The results also indicate that non-compliance was most common amongst sole traders and partnerships, confirming areas the Revenue have previously known as high risk. In 2001-02, further analysis has identified specific risk groups within the sole trader and partnership groups to aid refinement of the selection criteria for targeted enquiries.

1.23 We examined the approaches being developed by the Revenue to measure and understand the ways in which tax is evaded, again within the context of approaches being developed by academics and other fiscal authorities. The results of this work are summarised in Appendix 2. The key conclusions are:

- The Revenue appear as advanced as overseas fiscal authorities in their thinking and work on fraud measurement. The Revenue themselves closely monitor the work done by overseas fiscal authorities on measurement, and currently chair the Organisation for Economic Co-operation and Development Forum for Tax Administration Compliance Sub Group whose current work includes comparison of risk identification and use of random audit programmes in member countries.
- The random enquiry programme is designed to give estimates of the proportions of non-compliant taxpayers. It only covers registered taxpayers, however, and will also not find all under-reported income. The estimates therefore understate the likely true scale of non-compliance. The US Internal Revenue Service has attempted to estimate the extent of this under-recording across different groups of tax types and scales up the results of their taxpayer audits accordingly.
- Information obtained from the random enquiry programme is not broken down into that due to fraud or error. Doing so would enhance the value of the information in determining the most appropriate operational response, but would require a degree of subjective judgement about culpability in each case.
- The results of random enquiries, in terms of estimates of the monetary values of tax at loss are currently subject to wide margins of error. As the programme proceeds additional years data should enable reductions in margins of error. Further research could be done to see if the results of targeted enquiries can be used in statistical models to reduce uncertainty in estimates of tax at risk.
- As data for further years become available, the random enquiry programmes provide an opportunity to consider establishing performance indicators and targets for reductions in the monetary value of tax at risk.

## 7 Income Tax Self Assessment at risk by taxpayer type

Taxpayer	Percentage of cases generating additional tax yield in the following bands:				
	£0	£1 - £250	£251 - £500	£501 - £1000	£1001+
Sole Trader	51%	14%	10%	8%	17%
Employee	80%	11%	4%	3%	3%
Pensioner	88%	7%	2%	1%	2%
Director	82%	9%	3%	3%	3%
Other	77%	8%	7%	4%	5%
Partnership	53%	7%	10%	8%	22%
<b>Total</b>	<b>68%</b>	<b>11%</b>	<b>6%</b>	<b>5%</b>	<b>10%</b>

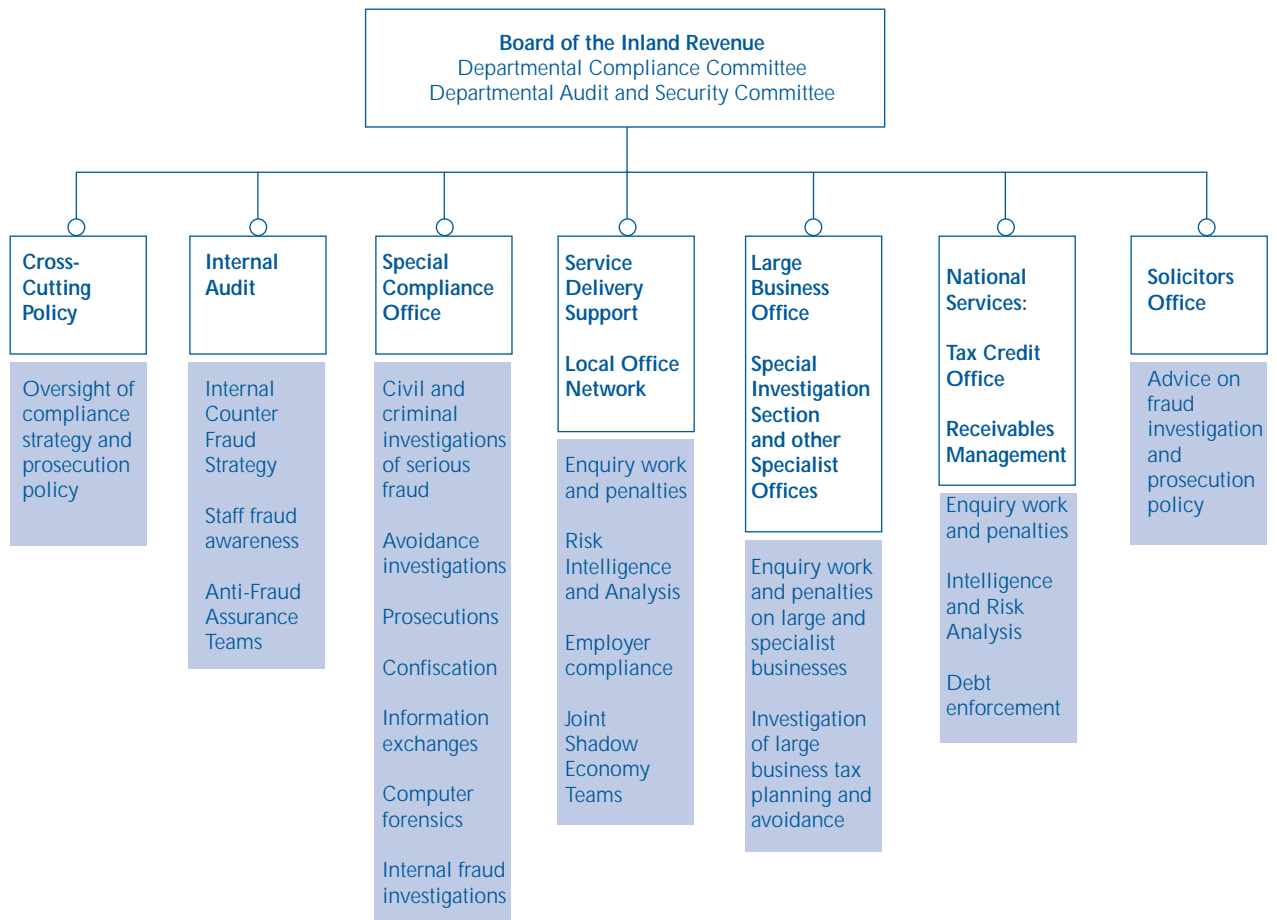
Source: : Income Tax Self Assessment random enquiry programme 1997-98

1.24 The Revenue have not produced estimates of the level of fraud in tax credit payments. To improve their understanding of the level and nature of the risks of error and fraud in tax credits, the Revenue are analysing a random sample of awards. The results of this work are being used to refine risk assessment and enquiry procedures for Working Families' Tax Credit and Disabled Persons Tax Credit and influence the design of compliance processes for Working Tax Credit and Child Tax Credit. Random enquiry programmes will be established for the new tax credits from 2004-05 onwards.

## Responsibilities for tackling non-compliance and fraud in the Revenue

1.25 Most parts of the Revenue are involved in delivering some aspect of the compliance strategy. The key elements of compliance that cover fraud involve enquiry and intelligence work on the tax returns of individuals and businesses in local or more specialist offices, and equivalent work by the Tax Credits Office on tax credit claims. The Special Compliance Office are responsible for the civil and criminal investigation of serious fraud, and work closely with the Revenue's Solicitor's Office, the Cross-Cutting Policy team and other policy and operational areas as necessary. The Revenue's Internal Audit team are responsible for the internal counter-fraud strategy. The key Revenue organisational units involved in tackling non-compliance are set out in **Figure 8**.

### 8 Main units of the Revenue involved in tackling non-compliance



#### NOTE

This does not reflect the full responsibilities of all teams in the Revenue in relation to tackling non-compliance. Revenue policy directors are responsible for legislative changes to encourage compliance and tackle non-compliance, and International and Capital Savings teams have very specific responsibilities that bear on compliance related issues.

Source: Inland Revenue



# Part 2

## Detecting and investigating fraud against the Inland Revenue

2.1 This part of the report examines the Revenue's approach to detecting and investigating fraud. It covers:

- enquiry work in local tax offices and progress in tackling fraud in the shadow economy;
- enquiry work on tax credits;
- the role of the Special Compliance Office and referrals for fraud investigation;
- civil and criminal investigation of fraud;
- confiscation and restraint.

### The effect of enquiry work in local tax offices

2.2 Targeted enquiry work by tax inspectors in local tax offices plays an important part in detecting tax fraud and maximising the deterrent effects of compliance efforts. There are two categories of targeted enquiries that apply to all Income Tax and Corporation Tax business and non-business sectors:

- 'full enquiry' covering all risks present in a taxpayers return;
- 'aspect enquiry' limited to one or more specific aspect of the return;

2.3 In the last four years the Revenue have exceeded their national and regional targets set for the number of enquiries by local tax offices. In the same period the return on the different types of enquiry work, in terms of additional tax yield identified, has remained fairly stable (Figure 9).

#### 9 Yield/cost ratios of enquiry work

Type of enquiry	2001-02	2000-01	1999-00	1998-99
Corporation tax <sup>1</sup>	5.9	6.3	4.9	5.1
Income Tax Self Assessment Business Full	1.3	1.1	0.6	0.3
Income Tax Self Assessment Business Aspect	3.1	2.6	2.6	3.3
Income Tax Self Assessment Non-business	5.3	3.9	3.4	3.8
Employer Compliance Reviews <sup>1, 2</sup>	3.0	2.7	3.1	3.0

#### NOTES

1. Full and aspect.
2. Employer compliance reviews involve checking that employers fully account for, and conform with, legal requirements for Pay As You Earn and Schedule E income taxes, National Insurance Contributions, student loan recoveries and payments of tax credits.

Source: Inland Revenue



## 10 The effect of targeted enquiry work in 2001-02

Type of enquiry	Number of enquiries taken up	Detection rate <sup>2</sup>	Additional tax identified (£m)	Percentage of cases involving penalties	Value of penalties and interest (£m)
Corporation tax <sup>1</sup>	70,052	Full - 75% Aspect - 53%	£515	Full - 37% Aspect - 1%	£38
Income Tax Self Assessment Full Business	41,643	76%	£150	23%	£37
Income Tax Self Assessment Business Aspect	62,377	73%	£83	3%	£8
Income Tax Self Assessment Non-business	232,545	Full - 40% Aspect - 65%	£220	Full - 13% Aspect - 1%	£15
Employer Compliance Reviews <sup>1</sup>	41,666	Full - 64% Aspect - 48%	£216	Not available <sup>3</sup>	Not available <sup>3</sup>

### NOTES

1. Full and aspect enquiry work.
2. The detection rate figure includes all enquiries settled in 2001-02 resulting in a change to returned figures, irrespective of whether these changes result in an immediate additional tax yield. For example, an adjustment to a detected trading loss understatement would have no immediate tax effect but would effect future tax years when less tax relief is claimed for smaller losses.
3. The Employer Compliance Review database does not distinguish between the value of additional tax identified and the value of interest and penalties.

Source: Inland Revenue

2.4 The first priority in an enquiry is to establish the correct figure of income tax, gains or National Insurance Contributions, before considering whether penalties are appropriate. It is not always easy to differentiate between what is error, negligence or even fraud, as it may be difficult to determine the intention of the taxpayer. Sometimes, the character of the case will change during the enquiry. For example, in cases that may begin with a relatively minor understatement the Revenue may uncover evidence to indicate serious fraud at which point the case is referred to the Special Compliance Office. Where negligence is identified the Revenue apply administrative penalties to deter similar occurrences. Penalties can be equal to the level of under paid tax, payable in addition to the tax, but are reduced dependent on the case circumstances. In most cases a settlement to include penalties and interest is negotiated and agreed with the customer. To apply penalties through formal procedures the onus is on the Revenue to demonstrate that negligence or fraud has occurred. Once a penalty is applied the onus is on the taxpayer to appeal to establish the error was innocent and does not involve negligence or fraud, but at any hearing the Revenue will need to demonstrate that they had evidence to support the determination made.

2.5 Enquiry work leads to the detection of significant numbers of cases resulting in additional settlements and the application of penalties (**Figure 10**).

2.6 The Revenue have moved towards greater central targeting of risk to ensure high risk sectors are clearly identified and local coverage in these sectors is maintained at adequate levels. Tax year 2001-02 is the first year in which new risk criteria drawing on the results of earlier random enquiry programmes are being applied to the selection of returns for targeted enquiry. It is too early to attribute improvements in yield and detection rates solely to changes in the basis of selection, though in year figures for 2002-03 on median yield are greater than the equivalent figures for 2001-02. The Revenue have taken other steps to improve the quality and impact of enquiry work:

- New training for local office staff was introduced in 1997 to supplement core tax training, and by 2002 has grown to over 100 modules designed to enhance core tax work and improve staff focus on compliance issues. The Special Compliance Office is involved in coaching schemes for local staff, and have developed in collaboration with local staff a new advanced investigation skills course aimed at enhancing the quality of enquiry work.

- The Revenue introduced a set of performance indicators by area and type of taxpayer in April 2002, which consider whether compliance processes and systems are working satisfactorily as well as traditional quantitative and qualitative targets. Indicators and targets, at both area and regional level, include the median level of yield per case to be identified by targeted enquiry work, whether actual resource usage on enquiry work is in line with planned resource usage, and customer satisfaction. Information derived from the new indicators is being used to monitor performance in 2002-03 and will provide a basis for future performance evaluation.
- Drawing on good practices already operated by some local tax offices the Revenue have, since April 2001, introduced dedicated local research and intelligence teams at Area Office level. They are responsible for researching available information and improving local tax office's understanding of the local population. The aim is to identify sectors and individual taxpayers where risks of non-compliance are high, allowing local teams to target their resources accordingly. As at January 2003, 71 teams had been established. The Revenue expect the Risk Intelligence and Analysis Teams to provide a more systematic and consistent approach to risk analysis, and teams at all of the Revenue Area Offices are now using commercial profiling tools and data interrogation techniques to select cases for enquiry.
- Complex personal returns from individuals are more likely to involve issues of non-compliance, and dealing with these cases in the past has involved different offices in checking the same returns. To improve customer service and oversight of enquiry work on this taxpayer group, the Revenue are currently establishing units in local tax offices to deal with their tax affairs.

2.7 Upon completion of a full enquiry, if the return is found to be incorrect the subject can be asked to sign a Certificate of Full Disclosure and a Statement of Assets and Liabilities confirming their complete disclosure of all tax irregularities. Where evidence emerges of serious omissions or inaccuracies this may lead to investigation of fraud and possibly criminal prosecution (**Case example C**).

### CASE EXAMPLE C

#### Prosecution for failing to fully disclose during enquiry

In 1995 a market trader was the subject of full enquiry covering his business accounts for three years up to 1994. Errors were found resulting in a negotiated settlement to cover unpaid tax plus interest and an administrative penalty. At the end of the investigation the trader signed a completed Certificate of Full Disclosure and a Statement of Assets and Liabilities confirming his full disclosure of irregularities. In 1998 the local tax office received anonymous information suggesting the trader had failed to disclose significant offshore investments in the Isle of Man and referred the case to the Special Compliance Office. Information from the trader's bank and other confidential sources confirmed the trader had provided a blatantly false statement of his assets and liabilities at the end of the local tax office enquiry. The case now fell within the Revenue's prosecution policy, and a criminal investigation began in 1999. The trader was arrested in 2000 and under interview admitted concealing his offshore investments and falsifying his accounts and tax returns. The trader came before the Crown Court in 2000 and pleaded guilty to charges of Cheat Contrary to Common Law. He was sentenced to nine months imprisonment and a confiscation order was made for £190,000 equivalent to the unpaid tax and interest.

## Tackling fraud in the shadow economy

2.8 Individuals and businesses operating in the shadow economy may be committing frauds against more than one government department. For example, individuals may be working for cash on which they do not pay income tax or National Insurance, and they may also be claiming benefits. In 1999 Lord Grabiner was asked by the Chancellor of the Exchequer to investigate the shadow economy; examine ways to move economic activity from illegitimate to legitimate business; and to recommend an action plan. In his report "The Informal Economy" (March 2000) he made a series of recommendations to combat tax and benefit fraud. The Revenue's progress in implementing the recommendations relating to detection and punishment is set out in **Figure 11 overleaf**. Action to prevent fraud in the shadow economy is covered in Part 3.



## 11 The Revenue's progress in implementing Lord Grabiner's recommendations on detection and punishment

Recommendation	Implementation Progress (August 2002)
<i>Detection</i>	
Give investigators the power to make routine "reverse searches" of the telephone directory.	The Revenue were included as a body permitted to carry out subscriber checks under the Regulation of Investigatory Powers Act 2000 (RIPA). The proposed secondary legislation to implement RIPA is currently under consultation.
Agree common guidelines for staff about what data sharing is legally permissible and how it should be carried out in practice.	A Quick Guide on disclosure of customer information was issued to all staff in January 2000, and a revised version issued in May 2002. The Department for Work and Pensions are using a similar format for their staff.
Build on joint work already started by departments by setting up a specific function for detecting and investigating shadow economy businesses.	64 Risk Intelligence and Analysis Teams set up to provide better intelligence to local offices on, amongst other things, individuals and businesses operating in the shadow economy.  20 Joint Shadow Economy Teams set up with HM Customs and Excise and the Department for Work and Pensions (paragraphs 2.9 to 2.11).
<i>Punishment</i>	
Establish a new statutory offence of fraudulently evading Income Tax, which could be tried in a magistrate's court.	A new offence of evading Income Tax was introduced from 1 January 2001 (codified in Section 144 of the Finance Act 2000). Forty two new fraud investigators were recruited in 2001 to investigate cases involving the new offence (paragraphs 2.13 to 2.16).

Source: Inland Revenue

## 12 Joint Shadow Economy Teams performance on direct tax cases

	Average yield	Detection rate
Joint Shadow Economy Teams	£5,992	79%
Equivalent local tax office enquiry work	£5,127	68%

Source: Departmental evaluations of Joint Shadow Economy Teams

2.9 The Revenue are working closely with HM Customs and Excise and the Department for Work and Pensions to tackle fraud in the shadow economy. Joint working enables departments to identify and work cases of common interest based on intelligence supplied by the departments such as declared levels of income. Currently 20 Joint Shadow Economy Teams operate across the country. The Revenue are involved in all 20 teams and in 2001-02 allocated 40 staff to this work, though HM Customs and Excise currently provide the majority of staff resources. The Department for Work and Pensions were originally in five of the teams but have now expanded into the remaining 15 teams. The Revenue are not planning to deploy increased resources on this work until robust evidence of the benefits emerge, but are working to improve the performance of the existing teams.

2.10 It is difficult to assess the impact of Joint Shadow Economy Teams on the amount of revenue being lost in the shadow economy without an estimate of the overall scale of the problem. Nevertheless, the Revenue report that in 2001-02 this work resulted in recovery of £317,000 in additional tax yield in 58 enquiry cases and £844,000 from ghosts and moonlighters<sup>4</sup>. The average yield and yield/cost ratio compares favourably with national performance on enquiry cases (Figure 12). These results were expected given the cases selected for joint working tend to be over the Value Added Tax threshold and equate to the highest turnover segment of Revenue's customer base subject to local office enquiry. The Revenue expect the average yield to improve as larger cases filter through in 2002-03.

2.11 From examination of departmental evaluations of Joint Shadow Economy Teams and visits to two teams we found that:

- There are a number of practical difficulties in the timing of joint work, such as the significant differences in timing for determining tax liability. For example, on Income Tax, the return can be submitted up to ten months after the end of the tax year, and up to 21 months after the end of the business accounting year, compared with the quarterly returns required on Value Added Tax.

<sup>4</sup> 'Ghosts' are individuals and businesses not registered for tax and unknown to the Revenue. 'Moonlighters' are employees registered for tax who also work on the side, usually for cash.

- Though Joint Shadow Economy Teams cover the entire country, the three Departments recognise the need to examine the risks associated with the shadow economy in different parts of the country to identify any gaps or mismatches in the distribution of staff. The three Departments have, therefore, jointly initiated a project to examine shadow economy risks across the UK.
  - There are four main sources of intelligence: direct from members of the public; cases referred by other officers; intelligence generated by Joint Team initiatives such as risk assessing local cash traders; and intelligence generated by other teams within the three departments. Many investigations are initiated using intelligence received from individuals, such as traders who are facing unfair competition from unregistered businesses. Given the value of external intelligence it is important that joint work is publicised, along with the mechanisms by which members of the public can provide Departments with information.
  - Levels of referrals from within the Departments are relatively low. To raise awareness and increase the levels of referrals from other teams within the three departments the Departments intend to publish a toolkit for staff about the work of the Joint Shadow Economy Teams.
- 2.12 The Revenue have in recent years established a number of other joint teams with HM Customs and Excise and the Department for Work and Pensions. Joint Fashion Industry Teams have been established to tackle common concerns in this sector. In Wolverhampton a multi-agency team has been established to tackle local areas of joint concern such as collusive employers and employees. Some Revenue staff are also involved in joint working on non-compliance involving 'gangmasters' operating mainly but not exclusively in the agriculture sector, typically associated with high risks of non-operation of Pay As You Earn, non-registration for tax and working and claiming benefits. The Revenue are keen to expand this type of joint working where there are clear benefits.
- 2.13 In 2001 the Revenue received £2.0 million to recruit 42 new investigators and seven managers to conduct criminal investigations with a view to use of the new offence of being knowingly concerned in the fraudulent evasion of Income Tax. The new offence can be tried in Magistrates' Courts allowing the Revenue to consider prosecution in a much wider range of cases. The Revenue see this as a particularly useful means of prosecuting those involved in fraudulent activities in the shadow economy. This can involve either those who fail to declare, or under-declare, their income tax, including employers and employees who collude in committing this offence. The Revenue will be more likely to prosecute if there are further offences against other public sector regimes, in particular tax credits, National Insurance Contributions, Value Added Tax or benefits.
- 2.14 To date the results from this new area of work have been limited. The new investigators have required training and experience on criminal investigation work. There has also been a lead-time for use of the new offence, which came into force in January 2001. Offences of deliberately failing to notify the Revenue of the need for a tax return will only have been committed since the October 2001 deadline for notification. As at December 2002 21 cases are being worked towards prosecution, and are expected to be the first cases where individuals will be prosecuted for evading tax and committing benefit fraud.
- 2.15 Expected numbers of referrals to the new investigation teams set up to tackle the types of fraud highlighted in Lord Gabor's report, have not yet materialised. Of those referred to date, many have been unsuitable for investigation, and there have been initial difficulties in defining appropriate referral criteria for local staff. Action is being taken to iron out problems and raise awareness about this new area of work to ensure potential prosecution cases are not inadvertently prejudiced by the actions of local office staff. Better liaison arrangements are being developed by the Special Compliance Office with local teams to develop best practice for handling this new type of prosecution work.
- 2.16 Lord Gabor highlighted the critical importance of joint working between the Revenue and the Department for Work and Pensions in tackling fraud against both the tax and benefit systems. It has taken the departments time to put in place the practical arrangements for the proper use of legal gateways to gather and share information. The Departments are seeking to resolve these issues by updating their existing memorandum of understanding, including developing and expanding the arrangements for information exchange. Differences in the speed with which each department can bring cases to prosecution have created practical difficulties for joint working, particularly as tax fraud, compared with benefit fraud, traditionally requires a longer elapsed time before evidence of an offence becomes available. Getting the evidence to prove a tax fraud for the purpose of criminal proceedings can be a complex matter, for example, where there are unrecorded cash transactions.





## The effect of tax credits enquiry work

2.17 Since 1999, tax credits have provided financial assistance to targeted beneficiaries such as working families and people with disabilities. Working Families' Tax Credit and Disabled Persons Tax Credit are administered by the Revenue's Tax Credit Office. The financial assistance is either paid direct to the claimant or received via the employer. Amounts awarded are based on the net weekly income of claimants and comprise a basic entitlement plus additions according to family circumstances.

2.18 The Revenue have established procedures to manage the risk of non-compliance based on both the Department for Work and Pensions' and their own experience on compliance. The Tax Credit Office is responsible for processing and risk assessing tax credit applications, working with a small number of local teams based within the local tax office network who carry out enquiries. As for tax enquiry work, where negligence or fraud is identified the Revenue apply administrative penalties to deter similar occurrences. Penalties can be equal to the level of overpaid tax credit, recoverable in addition to the tax credit paid, but are reduced dependent on the case circumstances. If at any point a case is considered to involve significant fraud it is referred to the Special Compliance Office, including cases involving repeat 'offences' and where there are signs of organised fraud by employers and employees working together to suppress real income levels or hours worked. The main features of the approach to tackling tax credits non-compliance include:

- The selection of cases for enquiry by tax credit staff based on completion of a risk score card for individual applicants, including cross checking applicants details to internal records and those of other government departments.
- The establishment of the Tax Credit Office's Compliance Team, whose responsibilities include research on non-compliance, referral of cases to the Special Compliance Office, development of procedures to help combat identity fraud, and the review of employer arrangements and instrument of payment irregularities.

- 'Intelligence teams' who match data provided by Working Families' Tax Credit and Disabled Persons Tax Credit claimants with data held on other Revenue systems associated with Pay As You Earn and Income Tax Self Assessment, and with data held by the Department for Work and Pensions on relevant benefits. This work enables the identification of inconsistencies and potential non-compliance, for example, an applicant claiming to be working over 16 hours whilst being in receipt of Jobseeker's Allowance. Intelligence teams are also conducting proactive research into identifying claims with a higher potential risk of non-compliance or fraud, for example, claims where a single applicant is working for more than 30 hours with several children of under school age.

2.19 The implementation of compliance work for tax credits has not been without its problems as highlighted in my *Standard Report on the Inland Revenue Appropriation Account 2000-01* (HC 335-XVI, February 2002) and by the Committee of Public Accounts<sup>5</sup>. Most notably, in the Revenue's arrangements for assessing risk and targeting enquiry work on employers and applicants, and information on the results and effects of enquiry work on employer non-compliance. The nature of these problems and the progress of the Revenue in addressing them are set out in detail in my *Standard Report on the Accounts of the Inland Revenue 2001-02* (published within *The Department for Inland Revenue 2001-02 Accounts*, HC71, December 2002).

2.20 The Revenue are making progress in tackling these problems. For example, the proportion of cases involving non-compliance and the additional yield identified has doubled between 2000-01 and 2001-02 (**Figure 13 overleaf**), reflecting refinements in the risk scorecard approach, better staff understanding of the risks of non-compliance and development of data matching and other proactive research on tax credits. While early results suggest detection rates will have increased again in 2002-03, it is difficult to assess the effects of this work in the absence of any overall estimate of non-compliance and fraud. In 2003 the Revenue plan to deploy extra resources to tax credit enquiry and intelligence work.

**13 Results of tax credit enquiry work**

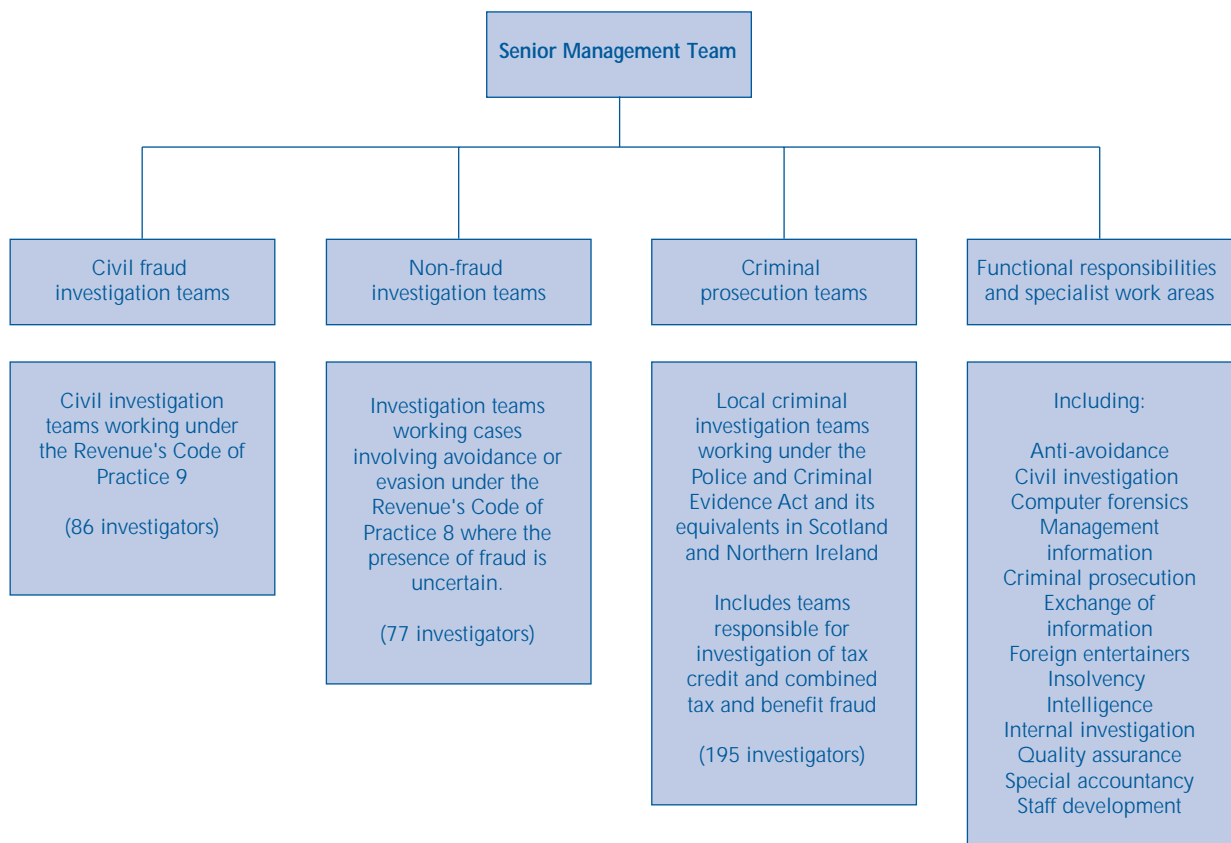
Year <sup>1</sup>	Amount paid and claimants	Number of enquiries conducted	Detection rate	Yield (including penalties and interest) <sup>2</sup> (£m)
2000-01	£4.6 billion paid to 1.2 million claimants	31,187	17% (5,302 cases)	£7.7
2001-02	£5.7 billion paid to 1.3 million claimants	22,617	36% (8,108 cases)	£15.4

**NOTES**

- 1999-00 was only a part year.
- Tax credit compliance work is managed across the Tax Credit Office and local tax offices. Current management information systems do not provide information on the cost of this work, though the Revenue are developing systems to provide this information in future.

Source: Tax Credit Office

**14 Organization of the Special Compliance Office**



Source: Special Compliance Office

## The Special Compliance Office's role in tackling fraud

2.21 The main role of the Special Compliance Office is investigating serious fraud and complex non-compliance outside the remit of local and specialist offices. Each year they investigate some 400 to 450 fraud cases, plus 325 to 450 avoidance or other non-fraud cases, and carry out various other functional and specialist responsibilities (Figure 14). The work is carried out in eight regional offices by over 600 staff, including 301 specialist fraud investigators, 90 investigators on avoidance and other non-fraud work. The Office have considerable information gathering and search powers at their disposal, though these are more constrained and specific in their application than those held by other law enforcement agencies such as the Police and HM Customs and Excise.

2.22 The Special Compliance Office recover around 12-15 times their total cost in terms of tax recovered without taking account of future savings or future or wider deterrent effects (Figure 15). Around 30 per cent of the additional yield generated by the Office comes from civil investigation of serious fraud. The remaining 70 per cent includes investigation of tax evasion where fraud may be present but the grounds for suspecting fraud are insufficient for fraud investigation, and also work on avoidance and from the Foreign Entertainers Unit (which generated yield of just over £30 million in 2001-02). The Office do not count the yield from criminal prosecution work as funds from fines and confiscation go direct to the Consolidated Fund via the courts. The reduction in the yield cost ratio in 2001-02 is explained by:

- increased costs associated with new criminal prosecution work on tax credit and 'Grabiner' work;
- a reduction in overall yield explained by a fall in yield from the Foreign Entertainers Unit linked to external economic factors, and an increase in mentoring activities by investigators across other Revenue offices.

2.23 Given the particular importance and challenging nature of their role in tackling fraud against the Revenue, the Special Compliance Office need sufficient staff with the appropriate experience. They are currently experiencing problems in maintaining a sufficiently experienced cadre of investigators, as investigators seek promotion opportunities elsewhere within the Revenue or leave to take up jobs in the private sector. These manpower issues led in 2001-02 to a 12 per cent shortfall in actual staff years used against the total planned staffing for investigator grades.

### 15 Financial return on all Special Compliance Office activities

Year	Cost (£m) <sup>1</sup>	Additional Yield (£m) <sup>2</sup>	Yield/cost ratio
2001-02	28.3	337	12.0
2000-01	24.9	378	15.2
1999-00	24.4	371	15.2
1998-99	23.1	338	14.6

#### NOTES

1. Total running costs excluding capital (including the costs of criminal investigation groups).
2. Tax actually recovered plus interest and financial penalties on all activities.

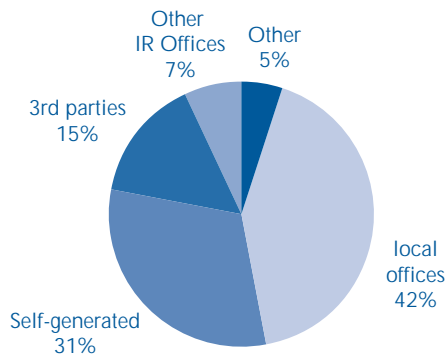
*Source: Annual reports of the Special Compliance Office*

2.24 The Special Compliance Office are also facing potentially significant expansion in their workload. Fraud and avoidance threats are constantly evolving and new areas of criminal prosecution work are developing, for example, on tax credits. In addition, following recent new legislation, they face a significant increase in the flow of intelligence and potential caseload. The Office are seeking to identify and implement measures to resolve their recruitment problems, for example, increased involvement in staff training and mentoring to raise awareness of their work, streamlining the recruitment process and publishing their policy on distance working. The Office have achieved notable success in tackling fraud, but face a challenge in responding fully to new opportunities, continuing to develop as a major investigative unit and maintaining their quality standards.

2.25 It is important that investigators are equipped with the right skills and competencies for investigation work. Fraud investigators are largely recruited from other offices within the Revenue, from staff already demonstrating considerable in-depth knowledge of tax and compliance work, and the competencies required for investigation work. Additional training is then provided. From 2000-01 all new criminal prosecution investigators attend the Professionalism in Security foundation course, which is university accredited and can contribute towards a degree in criminal justice studies, and advanced training opportunities exist in surveillance, informer handling, courtroom skills, expert witness training, advanced listening and negotiation skills.



## 16 Sources of referral for settled investigations 1998-99 to 2001-02



Referral Source	
Local tax offices	1,420
Self generated <sup>1</sup>	1,049
Third Parties/ other	508
Other Revenue offices	244
Other:	
Info exchange/intelligence	48
Customs and Excise	42
Voluntary disclosure	61
<b>Total</b>	<b>3,372</b>

### NOTE

1 Includes spin-offs from other cases and proactive research and project work.

Source: Inland Revenue

2.26 Computer forensic techniques are now widely used in fraud investigations and have been accepted by the Courts and others as a legitimate means of obtaining evidence. The Special Compliance Office have been a front runner in central government in such techniques, and the Office's Forensic Unit may be involved in up to 120 fraud investigations at any one time. Recently all nine members of the unit were involved in one major case. The demand for forensic techniques in fraud investigations will continue to grow.

2.27 To date the Special Compliance Office's management information system has had limited analytical capability. The Office are in the process of uprating and improving their central management information system, based on a proven system in use with overseas fiscal authorities and law enforcement agencies. It came on line in June 2002 and will enhance the Office's ability to monitor and manage investigation progress and resource use. The Office have also introduced an improved system for recording staff time spent on individual cases.

## Sources of fraud referrals

2.28 While local offices are the main source, the Special Compliance Office receive referrals from a wide range of other sources (Figure 16).

2.29 Clear criteria are laid down for when a case should be submitted to the Special Compliance Office by other parts of the Revenue. The Office use pre-defined risk criteria in selecting referrals for investigation. Sufficient and obtainable evidence must exist as well as scope to add significant value over what could be achieved by routine enquiry. There is a longer list of relevant features specified in the investigators handbook for Revenue staff, that include the value of any potential understatement and the circumstances that may suggest the possibility of serious fraud (Figure 17). Cases exhibiting these features must be submitted to the Special Compliance Office for consideration for investigation regardless of the suspected level of understatement.

## 17 Circumstances suggesting the possibility of serious fraud

Cases exhibiting any of the following features must be referred to the Special Compliance Office for consideration:

- false accounts have been deliberately compiled;
- alteration or falsification of documents supporting accounts or tax liability;
- there are grounds for suspecting the honesty of a solicitor, accountant or any tax advisor;
- the taxpayer or directors have conspired with a third party to defraud the Revenue;
- a Certificate of Disclosure or Statement of Assets signed during a current or earlier investigation turns out to be false;
- the potentially fraudulent taxpayer is a member of either House of Parliament or has a special status in the administration of justice or tax;
- there is suspected fraud or evasion using the vehicle of an offshore company or other foreign entity;
- informers have valuable information about a suspected fraud or substantial evasion;
- cases of 'phoenixism'<sup>1</sup>;
- cases of failure to notify chargeability or very late filing<sup>1</sup>;
- serious Pay As You Earn irregularities<sup>1</sup>.

### NOTES

1. Subject to financial thresholds and further aggravating features.

Source: Special Compliance Office, Investigation Handbook

- 2.30 The Special Compliance Office are dependent on other Revenue offices generating timely and high quality referrals, and recognise the importance of developing closer working relations with other Revenue offices and disseminating information about the risks of fraud. In the period 1998-99 to 2001-02 the number of and quality of referrals from local tax offices declined. As a consequence, the Office identified working relations between itself and local tax office teams as a key area for improvement. The steps taken to address this issue include regular liaison meetings with local teams, joint working of enquiry cases, mentoring exercises and involvement in training events for local tax offices.
- 2.31 The number of referrals from other parts of the Revenue appear low, particularly the Large Business Office, but this reflects the different types of non-compliance in the various areas of the Revenue's business. In the Large Business Office, which deals with the top 800 UK based companies, joint investigations involving the Special Compliance Office are common (as at August 2002, 35 avoidance cases and 15 civil investigations of tax fraud). The Large Business Office consider that large businesses are more likely to focus on tax planning and avoidance than be involved in tax fraud. The Special Compliance Office have identified frauds involving individuals with complex personal tax affairs operating within large businesses and potentially fraudulent avoidance schemes with implications for the work of the Large Business Office. There is scope for the offices to work more closely and steps are being taken to improve their links. A database has been established for cases involving joint working, and guidelines on respective roles and handling are being discussed. They are also exploring how they might build on existing liaison and joint training arrangements to make best use of Revenue powers and skills in combating avoidance and fraud.
- 2.32 Fraud investigators develop their own intelligence by following leads on existing cases where there may be links to other taxpayers involved in fraudulent activity or wider problems within the same sector. Where this looks likely to be of value the Special Compliance Office will establish a project often involving team working across regional boundaries. Such projects are a valuable source of both civil and criminal investigation referrals, and allow investigators to pursue frauds common within particular trade sectors (**Case example D**). As at July 2002 there were 68 live projects and a further nine under consideration. The projects cover a wide range of taxable activities, including property sales, commodity exchanges, professional sport and the use of tax havens. The Office have been particularly innovative in researching and pursuing the leads arising out of existing investigations through projects, but the resources that can be dedicated to this valuable type of work are constrained by the need to strike the right balance in completing existing investigations.

## CASE EXAMPLE D

### Project examining tax fraud in the hotel and catering industry

In March 1998 the Special Compliance Office received information about the use of unreported cash inducements to chefs to secure orders from the London hotel and catering industry. Initial covert enquiries indicated cash inducements to win orders were common in the industry, and that without them wholesale suppliers were unable to secure business. Suppliers were deliberately concealing the activities from the Revenue by creating fictitious invoices and withdrawing cash from the company bank account to pay the chefs. The suppliers were reducing their profits by inflating the purchases shown in their accounts, and the chefs not declaring the cash.

Given the evidence of systematic tax evasion within the London hotel and catering industry, a project was initiated to gather wider intelligence, including Internet research of industry magazines and hotel web pages. Ten major suppliers were identified for civil fraud investigation. The first five investigations led to disclosures of cash inducements and under reporting, along with the names of 92 chefs allegedly involved. Further investigations followed, and as at July 2002 negotiated settlements have been agreed with two chefs, resulting in recovery of £215,000 in tax and over £40,000 in administrative penalties and interest. The suppliers are still under investigation, but £575,000 in payments on account of expected additional liabilities has already been received. Of the remaining 90 chefs, 36 are under enquiry by local tax offices and the remainder are targeted for investigation in 2003-04. Evidence of other problems common to the sector, such as top up wages and wages to off record employees, have been referred to teams investigating individuals evading taxes and claiming benefits.

Five investigators are now involved on the project with over 150 suppliers and 200 chefs either under, or planned to be under, investigation. The expected yield of these investigations when completed is in excess of £20 million, and will lead to the prevention of a further estimated £3.5 million of annual tax fraud associated with false accounting and non-reporting of cash inducements in London alone. As intelligence suggests the problem is widespread within all major UK cities, investigations will be expanded across the UK, including contracts for large bulk purchases. The Revenue are awaiting information from the French fiscal authorities on UK chefs resident in France who have been prosecuted and fined for similar activities in Paris who may also be considered for investigation in the UK.

2.33 Since April 1999, the Revenue have had a free-call Business Anti-Fraud Hotline, providing a confidential facility for legitimate companies and their employees to give information, in confidence, about suspected fraudulent activities. However, reflecting its origins in July 1998 with the Contributions Agency, the Hotline is focused on the evasion of National Insurance liabilities by dishonest employers making use of social security benefits to reduce wage costs. The scope of this useful facility is unnecessarily restricted and we consider its value would be increased if the Hotline remit were widened to include all forms of tax and tax credit fraud.

2.34 The National Criminal Intelligence Service were established in 1994 to co-ordinate intelligence on criminal activity, including financial crime. Since 1998 the Revenue have developed links with the Service to raise the profile of tax fraud and improve the quality and quantity of financial intelligence. Four Special Compliance Office staff are on secondment to the Service, providing advice on tax matters and to identify tax related disclosures. The impact of new intelligence sources has led to a reassessment and reorganisation of Special Compliance Office intelligence capabilities and approach, and the establishment in 2001 of a single dedicated intelligence unit. Intelligence has proved valuable as a source of referrals for fraud investigation and in providing effective early warning of significant tax fraud and avoidance issues.

2.35 The Revenue must ensure they maximise the opportunities arising from increased intelligence to both investigate fraud and analyse trends and areas of risk. As disclosures increase, this will raise resource implications for the Revenue:

- The Revenue are working with the National Criminal Intelligence Service to resolve a number of issues that have to date prevented the Revenue addressing post-1998 disclosures identified as of interest but not yet reviewed. Additional Revenue resources to review cases have been seconded in 2002.
- The Special Compliance Office have for many years had a close relationship with the authorities in the Channel Islands and Isle of Man in relation to ongoing criminal investigations. They continue to foster this good relationship and receive full co-operation, including facilitating access to bank account information. The Channel Islands and Isle of Man authorities provide suspicious transaction reports to the National Criminal Intelligence Service, and in recent years, this intelligence has been available to the Special Compliance Office where it may relate to possible serious tax crimes in the UK. The Special Compliance Office see this as a positive and valuable relationship, which they are keen to maintain.

- The Anti-Terrorism Crime and Security Act 2001 came into force in December 2001, creating new information sharing gateways for the Revenue with the police, and allowing them to share information previously considered confidential. It will have far reaching consequences for the Revenue generally, not only in increased outward and inward transmission of intelligence and referrals for investigation, but also in their new relationship with law enforcement agencies.

- The Proceeds of Crime Act 2002, and the related European Union Money Laundering Directive, will establish a criminal offence of failing to report suspicion of tax evasion designed to achieve stricter compliance with money laundering regulations by financial institutions, lawyers, accountants, tax advisers and auditors. The Special Compliance Office envisage a large increase in the number of tax fraud related disclosures, including in relation to the use of offshore accounts and structures. Currently only the Office is authorised to have access to this material. The Revenue are exploring with the National Criminal Intelligence Service about how better use can be made of intelligence, including the resource implications for the Revenue.

2.36 The Revenue and HM Customs and Excise established a 'Closer Working Intelligence' project in 1999-2000 to look at how they could combine their customer and third party information and jointly generate intelligence through data matching in support of their investigation teams. One of the aims of the project is to establish a single catalogue of data and an approach to information sharing that can be applied across government and in relation to information exchanges between governments. The project is still in the development stage, though significant progress has been made in developing models for data analysis, creation of joint analytical teams, and resolving concerns about security, data protection and Human Rights legislation. While the project is targeted for completion in March 2003, intelligence is already being generated for teams and research being conducted into future non-compliance risks. For example, a data matching exercise has been conducted to identify those individuals and businesses that should be registered for both Income Tax Self Assessment and Value Added Tax but are only registered for one.

2.37 As new gateways for sharing information are legislated, the Special Compliance Office are increasingly working within wider networks of public and private sector organisations to tackle fraud. For example in 2002:

- The Special Compliance Office participated in an operation headed by the Northern Ireland Organised Crime Task Force. The case has yet to come to trial. The Revenue have agreed to participate in future cases where tax issues are involved.
- The Revenue for the first time became involved with the Financial Fraud Information Network, a group of public and private sector bodies established to safeguard the reputation of the City of London. The group shares intelligence on fraud threats, and collectively agrees the best course of action once a fraud is identified.

2.38 Longstanding arrangements for information exchanges with other fiscal authorities are being increasingly used and developed as a valuable source of referrals. The Revenue have 103 double tax agreements in place with other fiscal authorities, based around a model developed by the Organisation for Economic Co-operation and Development. The main purpose is to set out taxation arrangements for individuals and businesses whose tax affairs cut across national boundaries. All agreements contain provisions for exchange of information. In the period 1997-98 to 2001-02 total numbers of inward and outward exchanges, including automatic transmissions of information increased from 320,000 to over 1,024,000, often generating valuable information on existing fraud cases, and also referrals for fraud investigation (**Case example E**).

### CASE EXAMPLE E

#### Exchange of information leading to a major civil settlement

In 1999 the Special Compliance Office received a request for information on the UK activities of a dealer in a specialist trade sector in relation to a tax fraud investigation by an overseas fiscal authority. From the information provided by the overseas fiscal authority, the Office realised the case had major UK fraud implications and launched their own civil fraud investigation, resulting in a £20 million civil serious fraud settlement in 2001.

*Source: Special Compliance Office*

2.39 The Special Compliance Office have worked to raise awareness amongst investigators and staff in other parts of the Revenue about the value of information exchanges and have actively encouraged spontaneous exchanges of information. The Office implemented training and guidance to improve the quality of information shared as part of outward requests, as experience has shown this can increase the quality of information coming back and the value to enquiry work and fraud investigations. While double taxation agreements are working well in most cases, there are some areas of concern. For example, countries where fiscal authorities have weak or non-existent information gathering powers, or more notably countries with banking secrecy laws. The Revenue, using test case material, are currently working with the relevant authorities in these countries to rule out interpretation of double tax agreements as an obstacle to information exchange.

## Civil investigation of fraud

2.40 Most serious tax fraud investigations conducted by the Special Compliance Office result in civil settlements under which the taxpayer pays the tax due along with any financial penalty and interest. Civil investigation of suspected serious fraud involves providing a taxpayer with the opportunity to fully disclose all irregularities in their tax affairs no matter how serious the offences may be<sup>6</sup>. This procedure is known as 'Hansard' because it is guided by the 'Hansard' record of a statement made by the Chancellor of the Exchequer in response to a parliamentary question setting out the practice of the Revenue in cases of tax fraud. The aim is to encourage admissions and disclosures, the consequence of not doing so being the risk of the 'Hansard' procedure being withdrawn and the start of an investigation with a view to criminal prosecution.

2.41 The Revenue will always review a case for prosecution if it falls within their prosecution policy. If they discover that a taxpayer has sought to conceal irregularities after being offered a formal opportunity to fully disclose any irregularities under the 'Hansard' procedure they may also seek to prosecute. The Revenue reviewed their civil investigation procedure to take into account a recent case in the House of Lords involving the Human Rights Act 1998. In November 2002 the Chancellor of the Exchequer made a new 'Hansard Statement' to the effect that a taxpayer is now assured that the Revenue will not prosecute if a full and complete confession is made under the 'Hansard' procedure.



2.42 Civil investigations of fraud take between two to three years on average to complete (2.8 years from registration for investigation to the date of settlement). They appear very cost effective, for example, in 2001-02 generating around 30 per cent of the Special Compliance Office's additional yield (**Figure 18**). In the same year the Special Compliance Office's civil investigations, including non-fraud cases, achieved an estimated yield to cost ratio of 20:1. **Figure 19** sets out the outcomes of civil

investigation cases between 1998-99 and 2001-02. At the end of both 1998-99 and 1999-00 some 1,700 cases still under review were over one year in age. Delays in pursuing cases may reduce the likelihood of full recovery, though in many cases the Revenue will have obtained payment on account. Over the last two years the Office have reduced case backlogs and increased the numbers of cases where final recovery is greater than the initial assessment of tax at risk.

#### 18 Additional yield from civil investigations of serious fraud

Year	Investigations completed	Additional yield (£m) <sup>1</sup>
2001-02	308	93.7
2000-01	310	106.1
1999-00	361	96.7
1998-99	315	94.6

#### NOTE

1. Tax recovered plus interest and financial penalties. Data on costs of civil investigation groups are not maintained routinely.

Source: National Audit Office

## CASE EXAMPLES F AND G: Civil investigation of tax fraud

### Case F: Typical 'Hansard' case

The case started as a Special Compliance Office non-fraud enquiry, which identified a tax haven company advancing loans and share capital to a UK based business. They also identified an investment property owned by the same tax haven company and occupied by the controlling director and shareholder of the UK business. The director denied any interest in the tax haven company, stating that he was paying commercial rent for the property and that loans and advances to the business came from genuine non-UK residents.

Third party information brought the director's explanations seriously into doubt. Grounds existed to suspect the tax haven company was being used to receive diverted profits not declared for tax. The case was registered for civil investigation and the director was given a formal opportunity to disclose all irregularities. He conceded that he had disclosures to make and a detailed report was commissioned. The report revealed profits had been diverted abroad using false invoices and the funds used on the director's private expenditure. A settlement of over £500,000 was agreed.

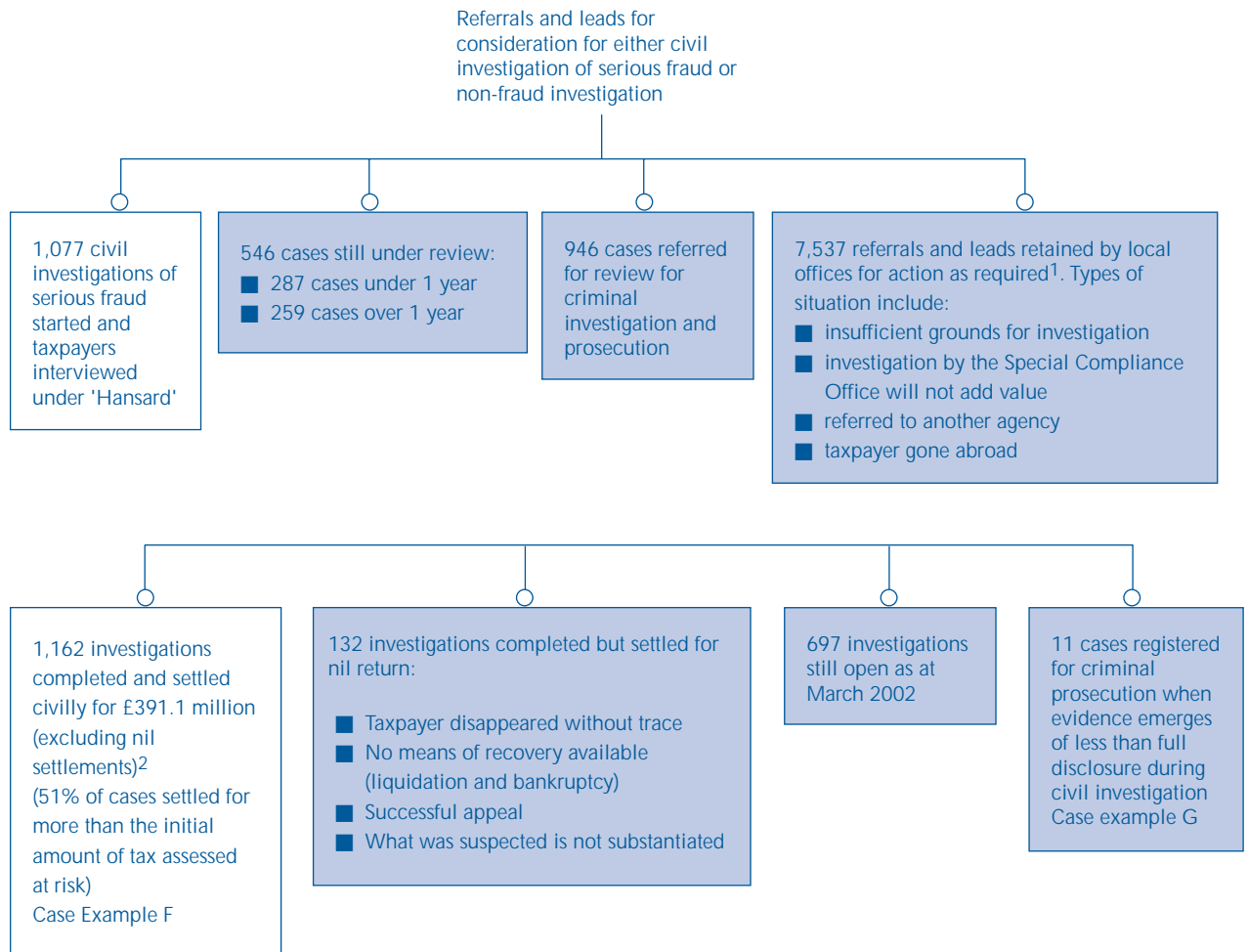
### Case G: Criminal prosecution following an incomplete disclosure after being offered 'Hansard'

An individual in full-time employment was also trading as a part-time window cleaner. During several local tax office enquiries information was obtained showing he had an overseas bank account and property. The case was referred for civil investigation and the individual was given a formal opportunity to disclose all irregularities. At the meeting he stated that he had admissions to make and promised to supply a full Disclosure Report. He subsequently withdrew his co-operation and did not submit the report.

The case was referred for criminal prosecution and the 'Hansard' procedure withdrawn. A search operation revealed evidence of undisclosed bank accounts and connections with a tax haven company, and third party information sources revealed further undisclosed UK investments. At his trial he pleaded guilty to 17 of 18 indictments, was sentenced to 12 months imprisonment and ordered to pay a confiscation order of over £100,000.

Source: Special Compliance Office

## 19 Civil investigation of serious fraud 1998-99 to 2001-02



## NOTES

1. The Special Compliance Office do not hold this data separately for civil investigation of serious fraud (Code 9 investigations).
2. The difference between the number of investigations started in the period and investigations settled is explained by the inclusion of investigations started in earlier years but settled in the period plus investigations started in the period but not yet settled.

Source: Special Compliance Office

## Criminal investigation and prosecution of fraud

2.43 Civil remedies for fraud need to be backed up by robust criminal investigation and prosecution policies. The Board of the Inland Revenue operates a selective prosecution policy on serious tax fraud, which the Special Compliance Office are responsible for implementing. The Board's policy is that no one should be encouraged to believe themselves immune from prosecution, the detailed criteria for prosecution necessarily varying from one type of offence to another. The Board acknowledges that it is not possible or appropriate to prosecute in all cases but regard certain types of tax fraud, such as frauds involving collusion or false documentation, and those committed by certain classes of individual, such as professional advisors, as deserving of special attention. Generally, the policy requires the presence of a defined heinous feature. The Revenue also have internal guidance on the appropriate financial limits for prosecution to be considered.

2.44 The Revenue are a prosecuting authority in their own right. In 2001 they conducted an internal review of their prosecution function to consider the implications of the 'Gower Hammond Report'. His Honour John Gower QC and Sir Anthony Hammond KCB, QC in March 2001 published a report into the role of HM Customs and Excise as a prosecuting authority<sup>7</sup>. The 'Gower Hammond Report' concluded that HM Customs and Excise should retain their prosecution function. The report, however, also recommended, amongst other things, changed lines of accountability for the prosecuting lawyers within HM Customs and Excise to ensure independence from investigation teams when making prosecution decisions.

2.45 The Revenue's internal review was completed in 2002. It recommended a number of improvements in the handling and resourcing of Revenue prosecution work. For example, improved training and better links between the Special Compliance Office and the Solicitor's Office including the development of project plans for cases where appropriate. Decisions on whether changes should be made in the wider arrangements for prosecutions are currently under consideration by Ministers.

2.46 Prosecution is not an efficient way of recovering evaded tax. While cost and yield are important, the Revenue's main aim in criminal prosecution is achieving conviction and the related deterrence impact. Other factors considered in deciding whether a case should be prosecuted include the existence of sufficient and obtainable evidence, whether prosecution is likely to be in the public interest and resource availability. Criminal investigation of tax fraud is very resource intensive, for

<sup>7</sup> *Report of the Review of Prosecutions Conducted by the Solicitor's Office of HM Customs and Excise, 2000.*

example, in 2001-02 costing some £11.7 million (around 40 per cent) of the Special Compliance Office's total costs. The time taken, on average two years, varies considerably from case to case (from registration for criminal investigation to the Board's order to proceed with the prosecution). The complex issues involved in establishing proof to criminal standard in significant frauds, and in some cases the action taken by the other party in attempts to frustrate the process, mean that a few of the most extreme cases have historically lasted up to ten years or even more. The Office have taken action to reduce the time taken on cases (see **Case example H**).

2.47 The Special Compliance Office generate most referrals for criminal investigation themselves. As **Figure 20 overleaf** shows, in the period 1998-99 to 2001-02 the Board of the Inland Revenue ordered prosecution of 263 defendants, 245 of which went to court resulting in 183 guilty verdicts or pleas (a 75 per cent conviction rate). There is always a degree of uncertainty about the outcome of any criminal prosecution, especially those involving complex and serious fraud, and it is inevitable that some will result in acquittal. To maximise deterrence the Revenue need to ensure that a high proportion of criminal prosecutions result in guilty verdicts or pleas, while at the same time not avoiding those cases where the outcome is less certain. With a conviction rate of around 75 per cent, the Revenue appear to have struck a reasonable balance. It is also important that in cases where the judge directs an acquittal, the prosecution offers no evidence or proceedings are stayed, any lessons are identified and acted upon. From examination of criminal prosecution cases we noted:

- Of the 183 convictions only 10 resulted in curfew and conditional discharge (5 per cent), whereas 108 (59 per cent) resulted in custodial sentences, indicating the generally high quality of cases taken forward by the Revenue and the seriousness with which the courts view tax fraud.
- Cases stayed before completion include one case where in 1999 the judge ordered the proceedings stayed on the grounds of delay. Following this outcome the Special Compliance Office conducted a thorough review of all stages of the investigation process and introduced new guidelines in 2000 to minimise delay (Case example H). The Office are looking to reduce the average length of criminal prosecution cases. In measuring average time the Revenue will need to differentiate between traditional tax fraud cases and newer work on tax credits or involving the use of new tax fraud offences.

2.48 There is no general offence of fraud under the criminal law and no offence of tax fraud, though as discussed earlier in this report a new offence of fraudulent evasion of income tax was introduced in the Finance Act 2000. In serious fraud cases the Revenue generally use the common law offence of cheat. In some cases, where

## CASE EXAMPLE H

### Action taken to improve the speed of criminal prosecutions

The Board in 1997 ordered the prosecution of two individuals. The criminal investigation had taken three years to complete, and while the overall time was acceptable there had been long periods of inactivity and delay. In 1999, a successful application was made to the Court to stay the proceedings on the grounds that excessive delays had occurred in the conduct of the investigation. The Judge commented that delays can bring enormous stress and strain upon people, particularly defendants and their family, and witnesses as well. In his view the delays in this case were inexcusable.

Following this judgement, a thorough review of the case was undertaken by the Special Compliance Office revealing sufficient concerns to warrant a wider review of criminal investigation procedures. An experienced Counsel was asked to comment on the investigation processes in the light of the judgement and the impending enactment of Human Rights legislation. This was followed up by a series of internal reviews each looking at specific areas of criminal investigation casework.

This work culminated in a seminar for all investigators on how delays can give rise to abuse of process problems, and the introduction of University accredited training for all new investigators. It also led to substantial changes in internal procedures designed to streamline the conduct of criminal cases. For example, the introduction of new guidelines designed to:

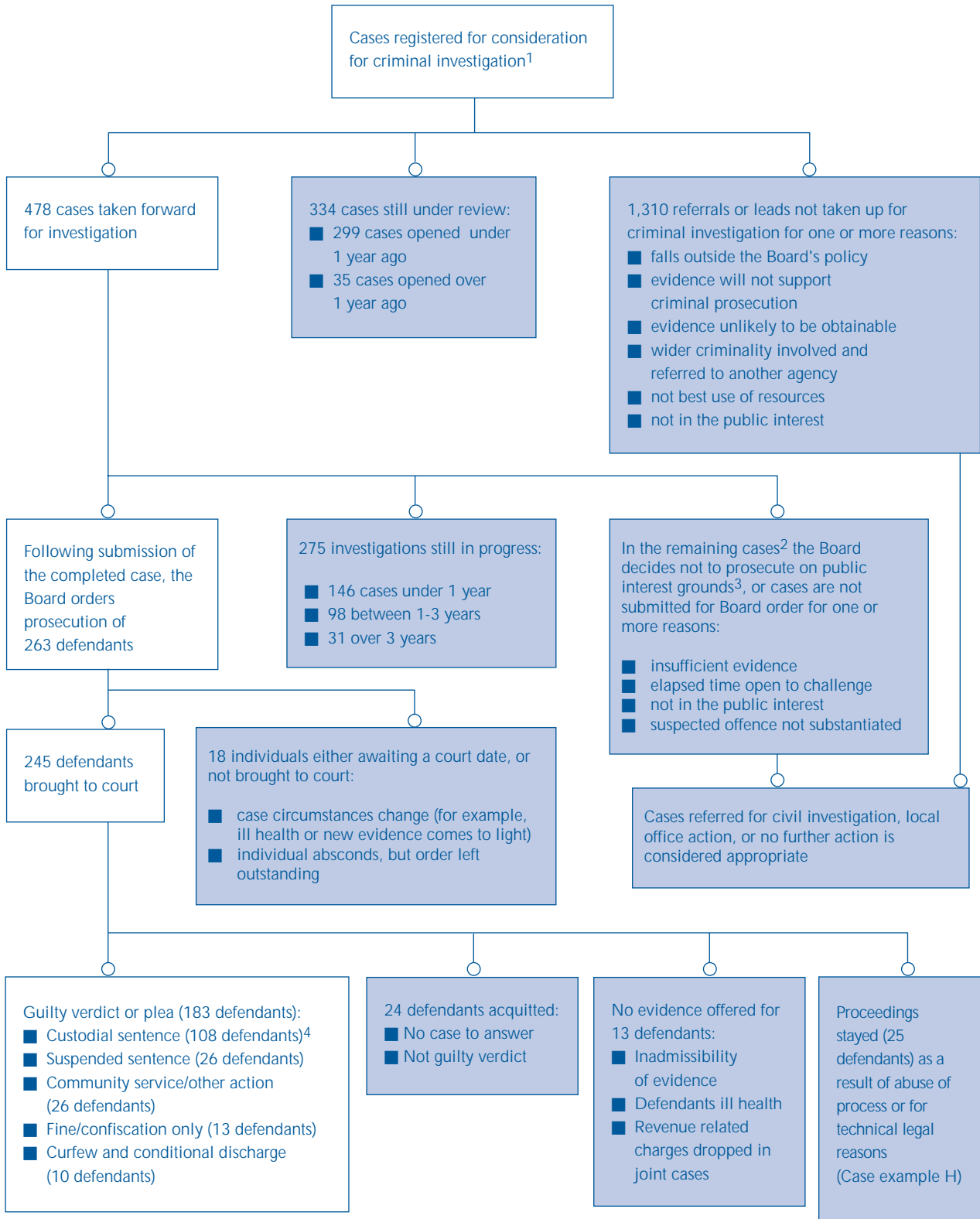
- speed up authorisations of arrest (and charge where appropriate), including lowering the level at which arrest can be authorised in certain types of case;
- simplify and clarify the form of reports on criminal prosecution cases;
- ensure cases submitted to the Solicitor's Office are also ready for consideration by the Board.

As the range of work for which the Office has expanded, particularly in the tax credit field, procedures are now continuously under review to ensure their applicability to all types of criminal investigation work.

deliberately incorrect accounts are submitted, the charge may be the statutory offence of false accounting under the Theft Act 1968. In July 2002 the Law Commission announced its recommendation to the Home Secretary to repeal the eight offences of deception under the Theft Acts 1968-96 and abolish the common law offence of conspiracy to defraud, and to replace these with new statutory offences for fraud and obtaining services dishonestly. The aim is to simplify the



20 Criminal investigation and prosecution of serious fraud 1998-99 to 2001-02



NOTE

1. Includes 946 cases referred from civil investigation (Figure 19).
2. The total number of investigations completed and also submitted for Board order in the period were not retrievable from the Revenue's management information systems.
3. As defined in the Crown Prosecutor's Code of Practice (for example, terminal illness).
4. Sentences range from two months to eight years.

Source: Special Compliance Office

law on fraud while making it more comprehensible, effective, and responsive to developments in technology. As the Revenue prefer the use of the common law offence of cheat they will not be significantly effected by these developments.

2.49 To gain the most deterrent value from criminal prosecution the Revenue seek to select cases across all geographical areas and economic sectors of the UK (Figure 21). The presence of forgery and deception is a strong feature of the bulk of cases prosecuted across the country. The Special Compliance Office have introduced improved management information arrangements in 2002 to enhance their monitoring of criminal prosecution progress and coverage.

2.50 While acknowledging the existence of financial penalties and civil investigation, it is important to ensure that there are no taxpayers or tax credit applicants who, regardless of the seriousness of the fraud or evasion they are committing, perceive they are unlikely to ever face criminal investigation or prosecution. As at July 2002, of the 487 cases under review or being investigated, the majority involve individuals involved in medium and small enterprises with ownership or control over the business, or access to and control over cash. Compared to taxpayers who are taxed at source, these individuals have relatively greater discretion over what they declare to the Revenue in their annual tax return. Another significant

group involves professionals such as accountants, tax advisors and solicitors, who feature in 19 per cent of the live criminal investigation case load. There are very few criminal prosecutions involving other taxpayer groups, including those involved in less serious frauds.

2.51 On tax credit fraud, the Board of the Inland Revenue have established a prosecution policy consistent with their prosecution policy on tax fraud and which also has read across to the prosecution policy of the Department for Work and Pensions on benefit fraud. Tax credit fraud cases will be selected for criminal investigation if they are above a threshold value and exhibit certain aggravating features. In 2000, the Revenue received £1.9m to recruit 42 new investigators and seven managers to work on tax credit frauds. To date relatively few prosecutions have been carried out on Working Families' Tax Credit reflecting the time required in most cases for the threshold value for serious frauds to be breached, and the need to recruit and train new investigation staff. The Revenue do not have a legal basis to obtain third party information (for example, from banks) in support of criminal investigation of tax credit offences. This affected a number of potential investigations though precise numbers are unknown. The necessary legal basis has been provided for in the legislation for new tax credits which comes into force in 2003.

## 21 Criminal prosecution case load as at July 2002

Inland Revenue Region	No. of Defendants	Most Common Tax Offences	
London	125	Construction Industry offences	28%
		Forgery/deception offences <sup>1</sup>	28%
		Deliberate concealment	15%
		Corruption offences	15%
South England	61	Forgery/deception offences	68%
		Corruption offences	15%
		Deliberate concealment	14%
North England	58	Forgery/deception offences	64%
		Deliberate concealment	19%
		Corruption offences	10%
Midlands/East Anglia	39	Forgery/deception offences	61%
		Deliberate concealment	11%
Scotland	38	Forgery/deception offences	65%
		Corruption offences	26%
Wales	7	Forgery/deception offences	90%
		Corruption offences	10%
Northern Ireland	7	Forgery/deception offences	65%
		Corruption offences	35%

### NOTE

1. "Forgery and deception" cases will include: forgery, deception and misrepresentation involving (but not exclusively) order books and payable instruments; PAYE and National Insurance offences; use of false or forged documents including false statements of assets and certificates of disclosure; and false claims to repayments and allowances.

Source: Special Compliance Office

## CASE EXAMPLE I Working Families' Tax Credit fraud

The Police approached the Revenue with evidence from a wider investigation pointing to an individual whom they believed was fraudulently claiming Working Families' Tax Credits (WFTC). Revenue fraud investigations revealed that the individual was receiving income from the letting of properties he owned solely or jointly with his wife. Both the individual and his wife were arrested but made no comment at interviews under caution. Evidence was acquired pointing to false WFTC claims amounting to £25,000. The Board of the Inland Revenue ordered prosecutions, and the Crown Prosecution Service laid charges in relation to Police matters. The husband received a 3½ year custodial sentence, of which one year related to WFTC fraud. The wife was charged only with the WFTC offences for which she received a community service order.

### 22 Types of Tax Credit offences ordered for prosecution

Type of Offence	Proportion of cases ordered for prosecution
Forgery of documents	52%
Instrument of Payment fraud	29%
Forgery of documents and Instrument of Payment fraud	7%
Identity fraud	4%
Collusive employers and employees	4%
Government employee (three cases, one involving a Revenue member of staff and two involving staff from the Department for Work and Pensions)	4%

Source: Special Compliance Office

2.52 As at December 2002, 57 cases of tax credit fraud had been brought to court, 56 cases resulting in conviction (**Case example I**), with a further 28 cases pending. In eleven cases, a custodial sentence was given with the length of sentence averaging 15 months. Seventeen of these prosecutions involved related benefit offences and were jointly prosecuted with the Department for Work and Pensions. There is currently no offence of committing tax credit fraud, though this is being addressed in legislation for new tax credits, and so existing offences under common and criminal law are used. The individual value of the frauds committed is relatively small compared to tax cases, mostly ranging from £600 to tens of thousands, and in the most extreme case up to £100,000, and a range of different offences are involved (**Figure 22**). As the applicant population increases and new investigation powers come into force the Revenue envisage large increases in the future

number of criminal investigations of tax credit fraud. As at December 2002, 133 investigations of tax credit fraud are ongoing.

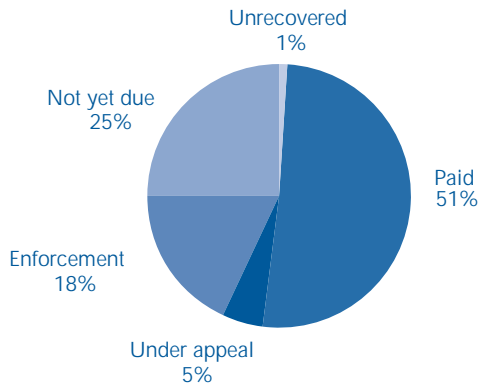
2.53 The Revenue take internal fraud very seriously and aim to prosecute wherever possible. The Special Compliance Office are responsible for investigation of internal frauds or frauds involving collusion between staff and external parties. In the period 1998-99 to 2000-01 three cases of collusion have been investigated resulting in 23 criminal prosecutions, 21 of which resulted in conviction. Nineteen of the defendants were convicted in 2000-01 in relation to one case of fraud involving the collusive interception of payable orders for tax repayments in Bootle. The tax officer responsible for the fraud created false identities for his 18 outside accomplices and submitted false repayment claims for tax overpayments during the previous six years. None of the individual payments exceeded £2,100 but collectively totalled £122,000. A further case of tax repayment fraud involving an official at another Liverpool tax office and 23 external accomplices was successfully prosecuted in September 2002, involving £72,000 in false tax repayments and single parent allowances over two years. The tax official was jailed for two years and ordered to repay £32,000 or face a further 15 months in prison. These cases aside, collusion remains a relatively small component of the Office's caseload.

## Confiscation and restraint

2.54 While the Special Compliance Office have always used conventional means of recovery, they have come to view confiscation and restraint powers under the Criminal Justice Act 1988 as an essential adjunct to a successful prosecution to deprive convicted fraudsters of the proceeds of their crime. It is used in conjunction with a Restraint Order to prevent the removal of the defendant's assets and to preserve their value for the purposes of meeting a Confiscation Order should one be made.

2.55 The Special Compliance Office's first use of confiscation was during a joint prosecution undertaken with HM Customs and Excise in 1995. Prior to 1995 the Revenue used their normal powers of assessment and recovery. In the period 1995-96 to 2001-02, the Office have made greater use of confiscation powers resulting in 34 Confiscation Orders obtained (totalling £17.3 million), 15 of which were obtained during 2001-02, in conjunction with 12 Restraint Orders. As at March 2002, £8.8 million had been paid into Court, 51 per cent of the value of Confiscation Orders issued since 1995-96, with just over 1 per cent of the amounts to be confiscated not recovered (**Figure 23**). These figures include the orders in recent years where enforcement is not yet due or complete. On cases where orders are due, the Revenue's recovery rate for 2001-02 exceeds 95 per cent.

## 23 Inland Revenue use of Confiscation Orders 1995-96 to 2001-02



Sums involved	£ million
Paid Orders:	£8.8
Not yet due:	£4.3
Enforcement action started:	£3.1
Under appeal:	£0.9
Unrecovered:	£0.2
<b>Total</b>	<b>£17.3</b>

### NOTE:

The Revenue can apply to the Crown Court for a Confiscation Order where a defendant has been convicted of a relevant offence or benefited from committing that offence. The amount to be confiscated is the lesser of the benefit of the crime or realisable assets. The order specifies the amount to be paid, the deadline for payment and the default sentence for non-payment (up to ten years imprisonment).

Source: Special Compliance Office

2.56 Over the last four years the Revenue have worked on developing their use of the Criminal Justice Act 1988 to recover the proceeds of the crime rather than simply the loss to the Exchequer as well as identify suitable cases for its application. In 2001 the Special Compliance Office for the first time used confiscation orders successfully to recover the wider proceeds of crime (**Case example J**). Other cases have followed and this will be a key consideration in future criminal prosecution. In a few cases confiscation has been hampered by the individual absconding overseas before being charged and convicted. It is also more difficult to confiscate overseas assets, particularly where property is involved. The Proceeds of Crime Act 2002 allows for restraint and confiscation even after an evader has absconded, and Mutual Legal Assistance Treaties<sup>8</sup> now exist between the Revenue and many overseas fiscal authorities.

2.57 Disqualification as a company director is an additional sanction that can add to the stigma of conviction and increase the deterrent value of prosecutions. In some Revenue prosecution cases the investigation team will

## CASE EXAMPLE J Prosecution and confiscation of the proceeds of the crime

In February 1999 the Special Compliance Office commenced a criminal investigation after receiving information that the principal shareholder and Chairman in a company was operating a concealed company bank account to fund his personal spending. Information obtained from the bank confirmed the existence of an account linked to the company finances and concealed from both the company auditors and the Revenue. Between 1990 and 1998, over £1 million of company monies had been diverted involving £400,000 of evaded tax. Given the deliberate nature of the concealment and the amounts involved, the Revenue executed seven search warrants in December 1999 at personal and business properties and the business properties of third parties such as the former company accountant and a major supplier. The company chairman was arrested by the police and interviewed under caution by two Special Compliance Office investigators. As he remained silent throughout the interview, successful prosecution was reliant upon examination of the seized documentary evidence.

A further 20 information gathering notices were served on a number of financial institutions. Evidence was obtained to show that the chairman had used the account to fund his lifestyle, including a UK holiday home, a villa and boat in Europe, and a number of luxury cars. Consequently a restraint order was successfully sought. The company chairman appeared at Crown Court in May 2001 and pleaded guilty to diverting company monies under Common Law Cheat. He was sentenced to two years imprisonment and debarred from serving as a director for four years. Subsequently a confiscation order was granted in an amount in excess of £1m, this being the benefit of the crime as opposed to the tax lost. This was the first time the Revenue had successfully applied confiscation powers to the full proceeds of the crime.

Source: Special Compliance Office

seek disqualification of the defendant as a company director where appropriate, but this is not mandatory and is up to the team concerned. HM Customs and Excise have recently worked with the Department of Trade and Industry to ensure disqualification is sought and applied in all cases where appropriate and the Revenue should consider adopting a similar approach.

<sup>8</sup> Agreements between fiscal authorities that, amongst other things, set out the arrangements for pursuing outstanding tax debts where the business or individual concerned has assets, or resides, in another country.





# Part 3

## Preventing fraud against the Inland Revenue

3.1 This part of the report examines the Revenue's approach to the prevention of fraud covering legislative change and redesign of tax systems, action to prevent fraud in the shadow economy and the feedback of lessons identified from fraud. It also covers the action being taken to tackle emerging threats, such as the use of offshore accounts and structures to evade tax, to raise staff fraud awareness and to understand better and influence customers' attitudes to fraud and compliance.

### Preventing fraud through legislative change, systems design and customer support

3.2 There have been a number of major changes in tax legislation and systems that have enabled the Revenue to reduce the risk of fraud and focus their resources on higher risk areas. A long-standing example is the use of taxation at source. Most income is subject to income tax deducted at source while for interest on investments, tax is usually deducted by the payer. For example, the Pay As You Earn scheme is not in itself a set of tax rules to calculate tax liability. It is a convenient and efficient method of collection for the Revenue, which compels employers to operate the scheme and pay over the tax so collected each month and reduces the risk of non-compliance.

3.3 A further example has been in tackling fraud in the construction industry, a long standing problem associated with the highly mobile nature of the industry workers, and difficulties in determining whether workers are employed or self-employed. The 'construction industry scheme' was amended in August 1999, establishing revised arrangements for the taxation of the one million workers in the construction industry. A new registration system for firms and individuals in the industry reduced the risk of undeclared cash payments to "ghosts" and "moonlighters" and steps were taken to increase the number of workers whose income would be subject to deduction of tax at source. The Committee of Public Accounts in its Report on Inland Revenue Appropriation Account 1999-2000 (HC 631, 2001-2002), concluded

that the new construction industry scheme had achieved significant impact, with over 100,000 new people identified who were not previously registered and estimated additional tax yield of £280 million in 1999-00.

3.4 To reduce the scope for error and help compliant taxpayers get their returns correct, the Revenue have sought to simplify systems and introduce various education and support initiatives. For example, the establishment of 'Business Support Teams' to educate and assist new employers. Also, in implementing the recommendations resulting from the 2001 'Review of Links with Business', the Revenue are aiming to bring themselves closer to business and to modernise the administration of the Corporation Tax system for large businesses. They are currently trialing a one-stop approach towards businesses applying for advance rulings about the tax effect of certain transactions (statutory clearance applications) covering, for example, company demergers and purchases of own company shares. Enabling initiatives will not deter determined tax evaders, but they allow the Revenue to deploy increased resources on tackling non-compliant taxpayers.

3.5 In planning for the introduction of new tax credits the Revenue, drawing on the lessons from earlier tax credits, have introduced legislation and new processes to address risks of non-compliance and enable customers to comply. For example:

- The introduction of automated pre-award verification checks against other internal and external databases. The same measure of income is to be used for new tax credits as for tax, facilitating such checks. Pre and post award risk assessment procedures are to be automated and will make increasing use of data matching.
- Awards to be based on the actual circumstances during the year of the claim rather than a snapshot in time to discourage manipulation of circumstances around renewal dates. Also, the removal of capital limits for establishing entitlement, removing an area of abuse under Working Families Tax Credit and Disabled Persons Tax Credit.



- The introduction of new third party information powers for investigators and a new criminal offence of tax credit fraud have already been highlighted in Part 2. This will go in hand with comprehensive enquiry powers and other new sanctions such as a statutory requirement to notify certain changes of circumstances with penalties for failure to do so. Warnings will be incorporated into the claimant form and scheme information to deter such abuses.

## Preventing fraud in the shadow economy

- 3.6 Lord Gribner, in his report "The Informal Economy" (March 2000), made a series of recommendations to prevent fraud in the shadow economy. The Revenue have made progress in implementing these (Figure 24).
- 3.7 Once an individual or business has started operating in the shadow economy the tax implications of legitimising their activity soon becomes a significant barrier to registering with the relevant authorities. The Revenue recognise the importance of assisting individuals and businesses to join the legitimate economy. For example, as illustrated by the establishment of a Tax and Benefits confidential help line and the arrangements whereby local staff may allow the payment of under paid tax in instalments over varying lengths of time dependent on the case circumstances.

- 3.8 The Tax Faculty of the Institute of Chartered Accountants in England and Wales suggested to the National Audit Office that the Revenue should consider a more flexible approach towards the payment of unpaid tax obligations incurred while businesses or individuals were operating in the informal economy. While the Revenue may sometimes allow payment by instalment arrangements for up to five years, current staff instructions specify that head office approval is normally required to extend the payment period beyond twelve months. On top of the usual penalty, interest is generally charged on overdue tax from the time that the liability accrued until the time it is actually paid, and agreement to an instalment arrangement depends on the submission of a considerable amount of detailed information. The Faculty believe workers in the informal economy will be more likely to legitimise their activities if the Revenue were more flexible about imposing interest on overdue tax and if the granting of instalment arrangements beyond twelve months was more formalised and easier to anticipate as a Revenue practice. The Revenue are, however, concerned to ensure that individuals or businesses who have been outside the formal economy for a number of years are not seen to have been given an unfair advantage by those who have complied fully.



## 24 The Revenue's progress in implementing Lord Grabiner's recommendations on incentives, prevention and publicity

Recommendation	Implementation Progress (August 2002)
<p><i>Incentives to join the legitimate economy</i></p> <p>Set up a confidential help-line to advise people how they can put their affairs in order.</p> <p>Increase the help that is given to people when they set up as self-employed</p>	<p>A 'Tax and Benefits' help-line was set up in July 2000 to advise people operating in the informal economy on the impact of joining the legitimate economy. The helpline has been publicised in two advertising campaigns (July 2000 and February/March 2001). Up to March 2002 the helpline</p> <ul style="list-style-type: none"> <li>■ took 39,198 calls of which 4,276 were from people operating in the informal economy;</li> <li>■ arranged for 302 people to be registered for tax and National Insurance Contributions;</li> <li>■ waived a total of £90,000 relating to 302 customers;</li> <li>■ referred 239 people to local offices.</li> </ul> <p>The total estimated amount of tax and contributions owed by callers is £1.3 million.</p> <p>A help-line for the newly self-employed was set up in January 2001, and an award winning pack "Starting Up in Business" and video made available to callers. By March 2002 the helpline:</p> <ul style="list-style-type: none"> <li>■ took over 300,000 calls;</li> <li>■ registered over 100,000 people for tax and contributions;</li> <li>■ led to 340,839 Starting Up in Business packs and 14,244 Cutting the Red Tape videos being issued.</li> </ul> <p>Local 'Right Track Teams' have been established to assist individuals and businesses detected in the shadow economy back into the legitimate economy. The Teams target unregistered businesses or individuals and provide help in registering for tax, issue reminders about deadlines for submission dates and help compile tax returns. Allotted Customer Service Managers, who provide support for up to two years, maintain the relationship with newly identified customers.</p>
<p><i>Prevention</i></p> <p>People should be required to tell the Inland Revenue as soon as they start up in business, not least so that they can be offered early advice, especially about record keeping.</p>	<p>A new offence of failing to notify the Revenue for Class 2 National Insurance Contributions purposes within 3 months of starting self-employment was introduced in January 2001. People who started self-employment on or before 30 January 2001 had until 30 April to register without incurring a penalty. During 2001 over 530,000 people registered for tax and National Insurance Contributions, 20% more than during 2000. Compared with the 1.6% growth in the number of self-employed, the increase in the number of registrations indicates an improvement in compliance in this area.</p>
<p><i>Publicity</i></p> <p>Publicising the incentives available for people to join the legitimate economy and the risks of staying in, or supporting the informal economy.</p>	<p>Successful prosecutions by the Revenue are now publicised in Tax Bulletins and on the Inland Revenue web-site.</p>

Source: Inland Revenue

## Learning from fraud and responding to new fraud threats

3.9 It is vital that the wider implications of all frauds are identified and acted upon promptly. We identified a number of cases where the Revenue have acted to redesign systems to prevent fraud based on the results of investigations. For example, the fraudulent early

liberation of individuals preserved pension funds ('pension busting'), first emerged in 2000 as a significant threat to the tax treatment of over £1,200 billion of savings in UK approved pension fund schemes (**Case example K on page 48**). It also threatened the well being of the schemes' intended beneficiaries in old age, as well as potentially increasing future reliance on state pensions.



## CASE EXAMPLE K: Fraudulent pension liberation schemes

### Background

Investments within pension funds are not taxed and tax relief can be claimed on contributions on condition that the fund is not used for any other purpose than the provision of relevant benefits (broadly retirement benefits). To qualify for tax relief, scheme rules must fulfil statutory conditions of approval or be approved by the Revenue. It is legal to transfer a pension when changing employer. The ceding pension organisation (usually an insurance company) must make the transfer in accordance with the Pensions Act 1995 or other relevant legislation for which the Department for Work and Pensions are responsible. Transfer can only be to another Revenue approved pension scheme and not to the pension holder.

### How pension liberation works

- The scheme organisers obtain an approved pension scheme, by creating a new company or taking over an old company and setting up a new pension scheme and obtaining approval from the Revenue. Refinements on this method include taking over an already approved pension scheme, forging approval documents, or more complex arrangements involving offshore structures.
- The scheme organisers encourage susceptible individuals to take up bogus employment within their company and transfer their pension. Those most likely to be approached include individuals with a preserved pension fund and in urgent need of cash, or those wealthy enough not to need a pension but keen to preserve their fund in an offshore account to evade tax. The organisers or their collaborators often target employees in firms involved in major redundancy programmes. Part of the marketing may involve encouraging the false view that the individual owns the pension fund. The ceding pension organisation is duped into transferring the preserved pension across to the bogus employer's scheme. The fund is returned as a cash lump sum to the individual for which the liberator will charge a fee, usually in the region of 25 per cent of the transferred pension fund value.
- The bogus company will cease trading before it has to submit tax returns to the Inland Revenue. The individual in receipt of the busted pension is unlikely to declare the income on their return.

Aspects of fraud common to these schemes include false representations to the Revenue for the purposes of evading tax; creation of bogus companies; and forgery. Taking the whole fund as a lump sum breaks the Revenue's rules for allowing tax-free growth of funds in approved pension funds, and the Revenue is deprived of tax that would have been properly due on pension payments in the recipient's old age. Many of those who liberate their pension in this way become wholly reliant on state aid at retirement age.

### Emergence and scale of the problem

The problem first came to the attention of the Special Compliance Office in 1997 when suspicions about policy encashments being made by two partners in a firm of independent financial advisors were referred to them. Subsequent investigation revealed that the advisors had illegally encashed their own pensions and were providing an encashment service for clients on a fee-paying basis. Both advisors were found guilty on six counts of cheating the Inland Revenue in May 2000 and jailed for three months. Further cases came to light in 1998 and 1999 following a disclosure to the Special Compliance Office by an offshore tax authority and referrals to the Revenue's Audit and Pensions Scheme Services and Occupational Pensions Regulatory Authority by scheme trustees in 2001 and early 2002. As at August 2002, 12 schemes involving around 1,350 individuals were under investigation, including two where criminal charges have been brought. In all, an estimated total of between £80 million to £100 million of pension funds have been liberated, entailing an estimated tax loss to the Revenue of approximately £35 million for which recovery is being sought.

*Source: Inland Revenue Pension Schemes Office*

3.10 As the full implications of the problem emerged in 2000, the priority for the Revenue was to address the underlying weaknesses in the system. In 2001, in addition to prosecution of some cases and ongoing criminal investigation in some others, the Revenue took the following action:

- the 1999 Memorandum of Understanding between the Occupational Pensions Regulatory Authority and the Revenue was amended to provide for exchanges of information to ensure pensions schemes are run safely and properly, and to clarify the respective steps each would take if further pension liberation schemes are identified;
- tax return guidance was made clearer so that taxpayers who have received early lump sum payments from pension funds are now legally required to declare these on their tax returns;
- using the Financial Services and Markets Act 2000, that provides for disclosures between the Financial Service Authority and the Revenue, practical arrangements were established to allow the Revenue to disclose confidential information to the Financial Services Authority in respect of individuals who were, or were effectively, acting as Independent Financial Advisers to facilitate pension liberation schemes, and to allow the Financial Services Authority to disclose to the Special Compliance Office on related criminal matters;
- following consultations with the main industry stakeholders, revised guidance was issued to pension providers, taxpayers and their advisers (Pensions Update 132, May 2002) designed to improve the controls over pension transfers. The new arrangements require pensions scheme administrators to satisfy themselves that requested transfers are only made to proper schemes and that requesting employers are bona fide.

3.11 Revenue contacts within the pension industry have advised them of a reduction in the number of suspect transfer requests, which they attribute to the introduction of Pensions Update 132. This has been confirmed by information obtained by the Revenue in the course of their investigations. The action taken to address 'pension busting' highlights a number of lessons for the Revenue and other government departments and agencies:

- The importance of effective liaison between operational areas and fraud investigators, and that the wider implications of individual fraud cases are fully considered and acted upon.
- The need to proactively identify areas of joint interest and identify the stakeholders in other key departments, alongside developing appropriate liaison arrangements, taking advantage of the new

and emerging legislative gateways for information sharing, rather than letting this be driven by emerging frauds.

- The need for rapid action to improve the underlying systems to prevent the proliferation of new or emerging types of fraud.

3.12 The Revenue and HM Customs and Excise jointly carry out assessments of the strategic threats to the Exchequer posed by external developments, including the risks of non-compliance and fraud. Recent threat assessments have included e-commerce, and the road haulage industry. Proposed future threat assessments include the shadow economy and the airline industry.

3.13 The growth of e-commerce was considered a potential threat to the UK tax base and since 1997, the Revenue have been working jointly with HM Customs and Excise and the Organisation for Economic Co-operation and Development to address the risks. Low set up costs, reduced barriers and ease of access to overseas markets present new opportunities for small businesses. These businesses may need guidance on complicated international tax issues at an early stage, otherwise there will be a risk of non-compliance through error. The anonymity afforded by trading on the net and the difficulties of tracing transactions, including the ability to move cash without involving banks presents new challenges for enquiry and investigation work. For these reasons it was concluded that significant risks of tax evasion exist, but that to date no material frauds have materialised. The Revenue continue to monitor developments and have:

- Drawn up an inventory of the key risks to direct taxes presented by e-commerce and an action plan of co-ordinated responses with HM Customs and Excise for implementation by March 2003. Action includes gathering intelligence from local Risk Intelligence and Analysis Teams on the compliance behaviour of a sample of businesses with an Internet presence to inform and improve future enquiry case selection and develop local skills in this area;
- The Revenue have maintained contacts with counterparts in Germany and Holland, who are developing Internet search tools for use in tax enquiries and investigations. The Revenue have also led on the development of the Organisation for Economic Co-operation and Development's guidelines for fiscal authorities on provision of guidance to small to medium sized internet-based companies on how to fulfil their tax obligations.

3.14 Where other fiscal authorities uncover major incidents of tax evasion the Revenue have considered the UK tax fraud implications. For example, in Ireland, the Comptroller and Auditor General for Ireland reported in 1999 to the Irish Public Accounts Committee about the evasion undertaken by certain Irish banks of Deposit

Interest Retention Tax. This is a withholding tax payable on certain deposits with the banks. A review of the non-resident (and hence tax-free) status of a sample of relevant deposits found that the non-resident declarations were invalid. An ongoing investigation by the Irish authorities has resulted in the recovery of almost £300 million of unpaid tax to date from financial institutions and taxpayers. The Revenue believe that analogous tax systems in the UK are less prone to this type of fraud, but are currently undertaking risk assessment work to determine whether there is any threat to the UK tax base.

## CASE EXAMPLE L

### Offshore structure designed to evade tax

In 1990 the Revenue received information linking the owner of a number of freight companies, who had not made tax returns for a number of years, with UK property dealings by two Jersey based companies. Under 'Hansard' the owner provided a signed assets and liabilities statement showing minimal assets together with a formal denial of any substantial involvement in the offshore companies or anything to confess to. New evidence of fraud emerged from a separate investigation into a Jersey based accountant linking the owner to the offshore companies.

Fraud investigations over the next seven years revealed the owner, with the assistance of the Jersey based accountant and a UK based solicitor, had established a complex set of offshore structures to conceal his ownership of profits and income from his UK businesses. The offshore structure included: two discretionary trusts in Jersey holding share capital from his companies; settlers of trusts in Switzerland and Gibraltar; 13 offshore companies registered in Jersey and Liberia; and dozens of nominee directors located throughout Europe. The Revenue calculated that over 17 years, £6.6 million of profits chargeable for corporation tax and £1.5 million of income and benefits chargeable for income tax had been deliberately concealed. He owed the Revenue £3.1 million in taxes.

At the Crown Court trial in January 1998, the defendant was found guilty, sentenced to seven years imprisonment and ordered to pay £3.1 million in confiscation. The sentence severity reflected both the scale of the fraud and the fact that the owner had blatantly lied to the Revenue, and it set a precedent for treatment of deliberate deceit by taxpayers. A detailed description of this case is at Appendix 3.

Source: Special Compliance Office

## Tackling the use of offshore accounts and structures

3.15 The use of offshore accounts and structures to commit tax fraud is not a new fraud threat, but Special Compliance Office concerns in this area have escalated in recent years. Around a quarter of serious fraud cases investigated by the Office in the period 1998-99 to 2000-01 (some 443 cases) involved the use of offshore accounts and structures to evade tax. In the same period the value of tax at risk involved, and the complexity of the concealment methods, have increased. The Office have no robust estimate of the level of funds held in offshore accounts that might be chargeable for tax, but they consider it likely that significant numbers of related tax frauds remain undetected. Even when detected, investigation is difficult given the constraints involved in obtaining information, and prosecution cases can be long and costly (**Case example L**).

3.16 Since the relaxation of exchange controls in 1979, it is legal for UK taxpayers to hold funds in offshore accounts, but illegal in most instances to fail to declare interest arising on these funds for tax purposes. Equally it is illegal to conceal from the Revenue monies arising from UK taxable activity which should have been declared as profits from that taxable activity when the profit was earned. Difficulties arise for the Revenue when taxpayers choose to hold or invest monies in financial institutions in countries with which the Revenue does not have exchange of information arrangements. Such countries may be offering considerable tax advantages to UK taxpayers. Improved access to offshore funds via credit and debit cards based in tax haven accounts and electronic banking services have increased the attractiveness of transferring funds offshore.

3.17 The Special Compliance Office have achieved successes in tackling individual cases, but tackling the root causes and increasing the risks of detection has proved more challenging. In the last four years significant progress has been made in improving sources of intelligence, and the Revenue have been actively involved in international and other action against harmful tax practices (**Figure 26**).

3.18 The Revenue are concerned that services offered by financial institutions have been exploited by taxpayers to commit significant levels of tax fraud by concealing assets offshore. In one case the Revenue have been successful in identifying and tackling systematic tax fraud by individuals using the services of a bank to conceal offshore transfers for the purpose of committing tax fraud (**Case example M**), raising concerns about the possible wider existence of similar cases. The case gave rise to a number of complex legal issues including the bank's legal obligation to preserve customer confidentiality. Following resolution of these issues, the Revenue are actively considering the wider implications.

- 3.19 Improved ability to obtain information on offshore accounts would heighten the risk of detection facing tax fraudsters and help act as a deterrent. The Proceeds of Crime Act 2002 offers potential for generating further intelligence on funds held in offshore accounts and structures. This will be particularly so when the persons within the reporting requirements of the Proceeds of Crime Act 2002 are extended by the European Union Second Money Laundering Directive to be implemented by June 2003. The Revenue are liaising with the banking sector, professional representative bodies and other key stakeholders about the implications of the new legislation and more generally on what further information it might be possible to obtain.
- 3.20 The US Internal Revenue Service have made significant progress in obtaining information on tax haven based credit card accounts. Since 2000, the Service have successfully issued information notices on three credit

card companies requesting information on customers' transactions. Information was initially limited to two of the credit card companies accounts billed to addresses in three Caribbean based tax havens, during 1998 and 1999. The Service have so far received details of 230,000 offshore accounts and 1.7 million transactions from one of the credit card companies.

- 3.21 The response exceeded the Internal Revenue Service's expectations and provided a revised indication of the potential extent of tax evasion using offshore centres. Based on this information, the Service estimate that as many as two million US citizens may have debit or credit card accounts with offshore accounts, compared with the 170,000 tax return filers who admitted offshore account ownership during 2000. Initial review of a small proportion of the records has identified cases indicating significant unreported income that could potentially involve fraud by hundreds of individuals. A subsequent petition by the Service to a US federal court in March 2002 has sought account details from a third credit card company of cards issued by banks in over 30 countries, more than 20 of which are tax havens. The Revenue have consulted with the US Internal Revenue Service and are considering the potential implications for the UK.

## 26 Action against harmful tax practices

### Finance Act 2000

- The Finance Act 2000 allowed the UK to enter into tax information agreements with countries to enable the Revenue to receive information about foreign transactions of UK taxpayers currently unavailable because no agreement for effective exchange of information existed. It also extended the Revenue's powers to obtain information from third parties for exchange of information purposes, allowing the Revenue to request more information about UK taxpayers from foreign authorities. It also extended the Revenue's power to receive details of savings income paid to all individuals on a reciprocal exchange of information basis. These changes allowed for more effective two-way exchanges of information with countries where there are significant transactions involving UK taxpayers.

### Organisation for Economic Co-operation and Development (OECD):

- The Revenue was part of the OECD's Special Project Team that developed a model tax information exchange agreement for 'tax havens' (published in April 2002). 31 'tax haven' jurisdictions have made commitments to the OECD to achieve effective exchange of information in criminal cases from 1 January 2004 and in all other cases from 1 January 2006.

### European Union (EU):

- The UK supports the EU Mutual Assistance Directive (77/799/EEC) which allows members to exchange information on request, spontaneously and automatically, to combat international tax evasion and avoidance. It has been in operation since 1979. The EU adopted its Second Money Laundering Directive in December 2001. All member states are committed to implementing its provisions by June 2003. This will mean that a range of non-financial institutions, including accountants, lawyers and tax advisers will now be required to maintain anti-money laundering procedures and to report suspicions of money laundering to law enforcement authorities. It is hoped that this will improve standards of due diligence across the regulated sector and deter individuals in these firms from facilitating transfers of criminal funds, including in some cases the proceeds of tax evasion.

## CASE EXAMPLE M

### Tax fraud involving concealment of offshore transfers

From 1985 the Revenue had concerns about the use of a bank's sundry parties' account used by customers to transfer funds to offshore accounts which were not subsequently reported for tax purposes by the tax payer. Banks normally use sundry parties' accounts for isolated local branch transactions that do not involve customers who have a current account. Following investigation of a case first identified in 1992, the Revenue obtained evidence in 1995 that individuals were using the bank's sundry parties' account to conduct substantial and systematic tax fraud.

Over the next five years the Revenue were able to use their information gathering powers to obtain evidence that is expected to produce around 450 cases of tax fraud with an estimated recovery of £90 million including tax interest and penalties. To date 51 cases have been settled with £5.1 million tax recovered and a further £5.1 million levied in penalties and fees. The remaining cases are to be completed by an 11 member team over the next five years. A more detailed description of this case is at Appendix 3.

Source: Special Compliance Office



## Raising staff fraud awareness

3.22 The Revenue recognised the need to raise staff fraud awareness following some collusive frauds in the mid to late 1990's, including collusive and fraudulent repayments of tax. In September 2000 they introduced an Internal Counter-Fraud Strategy designed to promote an anti-fraud culture and reduce the opportunities to perpetrate internal fraud. The Revenue's Internal Audit Office implement the strategy, with oversight from the Revenue's anti-fraud liaison group. A number of initiatives have been introduced under the strategy:

- a confidential Anti-Fraud Telephone Hotline to enable staff to report suspicions of internal and collusive fraud;
- a programme of fraud awareness workshops which, as at April 2002, had been attended by over 60,000 of the Revenue's 75,000 staff, and enhanced training and awareness for staff in high risk areas such as tax repayments;
- a programme of surprise audit visits potentially covering all areas of the Revenue, introduced during 2000-01 and continued in 2001-02;
- electronic risk profiling of on-line activity by all Revenue staff to identify possible fraudulent activity, which has already resulted in the detection and investigation of a collusive tax repayment fraud;
- enhanced internal publicity of the Revenue's Conduct and Discipline Code and the consequences of being caught illustrated by real cases.

3.23 The Revenue recognise the need to sustain their staff fraud awareness efforts, and are proposing to follow up the workshop programme with a telephone survey of local office staff and ensure all staff participate in the fraud awareness initiative. The focus of the initiative has been predominately on internal fraud, though the Revenue have recognised the need to also cover external fraud in future work. The Special Compliance Office are doing more to raise the profile of fraud and the nature of fraud risks through greater contact with other offices within the Revenue. This work will be enhanced by the introduction of the new tax fraud strategy. Unlike the practices adopted in many private sector organisations such as banks, there is currently no single forum or grouping that brings together managers from across the Revenue to discuss and share information on known and emerging external fraud risks.

## Understanding and influencing customers' attitudes to compliance and fraud

3.24 While tax is generally perceived as necessary in principle by most taxpayers, there are varying attitudes to compliance, and there will always be people unwilling to comply or co-operate with the Revenue. The design of compliance approaches should be based on a good understanding of taxpayer's attitudes to compliance. The Revenue have examined practices on taxpayer surveys from abroad, including approaches used by the Australian Tax Office. In 2002 they commissioned a survey designed to examine the likely effect of enquiries on the future compliance behaviour of five business groups, including cash traders and expanding businesses.

3.25 Before 2001 the Revenue had not tested the effect of its various approaches to compliance, and so did not know where to concentrate their efforts to 'lever' the greatest levels of compliance from existing resources. To determine where their efforts should be concentrated they commissioned in March 2001 quantitative research ('the leverage trial') to test the response of a high risk taxpayer group to five different compliance approaches:

- a friendly non-threatening offer of help;
- presenting a moral case for paying tax;
- referring to concerns about compliance and warning of increased likelihood of selection for enquiry;
- referring to concerns about compliance, warning of increased likelihood of selection for enquiry and referring to the penalty sanctions for fraud or negligence;
- referring to concerns about compliance and the pre-selection of the return for full enquiry.

The results of the exercise are now coming in and being analysed, and should provide the Revenue with a clear indication of the approach most likely to encourage compliance.

3.26 The Revenue when assessing the yield to cost ratio of activities to tackle non-compliance do not take into account the quantitative effects of future deterrence. The Revenue believe the effects are substantial, as indicated by some limited research in this area in the mid-1980s on the deterrent effects to individual businesses who had been the subject of an investigation to see whether they remained compliant in subsequent years. The results showed improved levels of compliance were maintained for at least five years, effectively doubling the direct yield. The development of the 'leverage approach' presents opportunities for increased evaluation of the deterrent effects of different compliance approaches. Measuring the extent to which non-compliant offenders re-offend, or have in the past

misled the Revenue, is another potentially useful indicator of deterrent effects. The Revenue do not monitor and evaluate recidivism amongst those subject to either enquiry or fraud investigation, or who have been found to have previously misled the Revenue.

3.27 Tax amnesties involve forgiving or writing-off tax fraud in past years and are normally offered on condition of full disclosure with tough sanctions for those who do not use the opportunity to legitimise their affairs. The Revenue have not favoured tax amnesties, have never held a general amnesty, and have no plans to do so. In his report on the informal economy, Lord Grabiner came down against amnesties for a number of reasons including the practical difficulty of defining an amnesty precisely enough to make it workable and lawful. For example, resolving the human rights implications of a tax amnesty that did not extend to those already under investigation, as well as potential discrimination against compliant taxpayers. The Revenue have examined the tax amnesty experiences of overseas fiscal authorities and have concluded that any initial positive returns have been outweighed by the longer-term negative effect on compliance as taxpayers are tempted to wait for the next amnesty and lose the incentive to comply. The Revenue, however, believe that it is important to continue to review the emerging evidence of the effect of tax amnesties overseas.

3.28 One of the major challenges facing the Revenue is making taxpayers recognise that tax evasion is a crime and the serious repercussions of not paying taxes, not only for the individual taxpayer, but also for society at large. Publicity and education are important ways of influencing public attitudes. Unlike HM Customs and Excise and the Department for Work and Pensions, the Revenue have not launched a national publicity campaign to raise public awareness about the unacceptability of fraud. They are looking at the lessons they might draw from these publicity campaigns and whether a similar campaign targeted against tax fraud would be worthwhile.

3.29 The effectiveness of compliance and counter-fraud activities is dependent on public perceptions about the risks of detection, and awareness of the consequences of being caught. It is therefore important that the existence and effectiveness of such activities are well publicised. The Revenue have made some use of publicity of specific compliance activities to raise the profile of their work, but there is scope to do more. As a consequence, some of the Revenue's successes, such as the £90-105 million annual yield from civil investigations carried out by the Special Compliance Office have gone relatively unheralded. Action might include separate publication of the work of the Special Compliance Office, and greater use of advance publicity to indicate forthcoming compliance work in specific areas or sectors as a means of encouraging voluntary disclosure.

## 27 Overseas approaches to publicity on tax fraud

### US Internal Revenue Service

The 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.

### Australian Tax Office

The Australian Tax Office, on its "ATO assist" website, provides advice for investors on the risks of aggressive tax planning, where the boundaries between legitimate tax mitigation and tax evasion may be transgressed. It also issues "Taxpayer alerts", intended to provide an early warning of the Tax Office's concerns about significant and emerging potential aggressive tax planning issues or arrangements that the Tax Office has under specific risk assessment and is considering their legality and propriety. The objective of the alerts is to put people on notice that the Tax Office may disagree with claimed tax benefits. Recent examples of areas covered in "Taxpayer alerts" include the taxable status of Education or Scholarship Trust Arrangements, Home Loan Unit Trust Arrangements and Internet Marketing Expenses Schemes involving tax haven based internet marketers.

*Source: National Audit Office*

Compared with the US Internal Revenue Service and the Australian Tax Office, the Revenue publicise relatively little information on new and emerging tax threats and specific counter-fraud activities (Figure 27).

3.30 On publicising successful fraud investigation cases, the Revenue are constrained by taxpayer confidentiality issues. They cannot reveal the details of individual civil investigation cases, and in criminal prosecutions can only make public what is actually said in Court. If a tax evader pleads guilty, evidence is not heard and therefore cannot be made public. Where appropriate the outcomes of criminal prosecutions are publicised in 'Tax Bulletins', and on the Revenue web-site. However, the Revenue accept that, other than when high profile individuals are involved, they have had limited success in attracting national media coverage of their criminal prosecution cases. This undermines the main aim in criminal prosecutions of achieving the maximum deterrent effect. In March 2001, the Special Compliance Office introduced a revised press handling strategy and has appointed press liaison officers in each of its regional offices to attempt to raise the profile of their work within the regional press and local Department newsletters, specialist and national press. The Revenue are also considering the possibility of highlighting successful prosecutions through slots on regional radio.

Questions 1 to 9 below to check if you need supplementary information. Pages 6 and 7 of your Tax Return. If you answer 'Yes' to any of the questions, you should read the Orderline for a Guide if I haven't sent you one with your Tax Return. If you answer 'No' go on to the next Question. Ring the Orderline on 0845 9000 604 for any you need (closed Christmas Day and New Year's Day).

Q1

Were you an employee, or office holder, or director, or agency worker or did you receive payments or benefits from a former employer (excluding a pension) in the year ended 5 April 2002?

NO  YES

Q2

Did you have any taxable income from share options, shares or share related benefits in the year? (This does not include dividends, or dividend shares ceasing to be subject to an Inland Revenue approved all-employee share plan within 3 years of acquisition they go in Question 10.)

NO  YES

Q3

Were you self-employed (but not in partnership)? (You should also tick 'Yes' if you were a Name at Lloyd's.)

NO  YES

Q4

Were you in partnership?

NO  YES

Q5

Did you receive any rent or other income from land and property in the UK?

NO  YES

Q6

Did you have any taxable income from overseas pensions or benefits, or from foreign companies or savings institutions, offshore funds or trusts abroad, or from land and property abroad or gains on foreign insurance policies?

NO  YES

Have you or could you have received, or enjoyed directly or indirectly, or benefited in any way from, income of a foreign entity as a result of a transfer of assets made in this or earlier years?

NO  YES

Do you want to claim tax credit relief for foreign tax paid on foreign income or gains?

YES  NO

Do you receive, or are you deemed to have, income from a trust, settlement or the residue of a deceased person's estate?

NO  YES

NO  YES

NO  YES

YES  NO

NO  YES

NO  YES

YES  NO

NO  YES

YES  NO

NO  YES

FOREIGN TRUSTS ETC



# Appendix 1

## Study Methodology

### Introduction

- 1 This report on the Revenue's efforts to tackle external fraud was completed in parallel with two other 'value for money' reports examining frauds against HM Customs and Excise and the Department for Work and Pensions. We developed a shared framework and methodology for the three reports.

### Semi-structured interviews

- 2 We carried out interviews with policy-makers, central and regional management and operational staff in the Revenue drawn from across the Department and in particular those areas with a strong focus on ensuring compliance. These included local and regional staff from the Service Delivery Support Division and the Special Compliance Office, Large Business Office, Tax Credit Office, Internal Audit, and the Audit and Pension Scheme Services. The aim was to obtain information and views on the main frauds, the Department's approach to tackling them and the results of their actions.

### Evaluation of fraud measurement methodologies

- 3 We employed Business Strategies, an economic consultancy firm, to review the methodologies used by the three Departments in measuring and analysing fraud. The consultants reviewed the validity and reliability of the various methods employed by the Departments, and reviewed current academic research on measurement and the approaches used in other countries to determine whether alternative methods might be available for the Departments to consider. The results for the Revenue are summarised in Appendix 2.

### Risk management

- 4 We employed risk management consultants, Vivas Limited, to develop a good practice checklist of fraud risk management. The consultant reviewed examples of the Revenue's approaches to risk management and compliance and compared this with the good practice checklist to identify areas where the Revenue's fraud risk management was well developed and areas where improvements could be made.

### Fraud detection, investigation and prevention

- 5 We employed Control Risks Group, a business risk consultancy, to develop a best practice checklist covering the prevention, detection and investigation of fraud. This was used to examine the Revenue's approach and performance based on data obtained through a questionnaire completed by the Department. The consultants assisted us with the interpretation of the results.

### Data-sharing and matching

- 6 We developed a set of high level questions to determine the approach to and extent of use of data sharing, data matching and other innovative techniques in tackling fraud. They were designed to determine the extent of each Department's progress in:
  - addressing the complex legal and other issues associated with data sharing and matching;
  - taking forward data sharing and matching, identifying good practices, the financial and other beneficial outcomes of exercises undertaken to date, and the barriers to further development.



## Third-party stakeholder consultation

- 7 We consulted the following organisations and provided them with an opportunity to comment on the Inland Revenue's approaches to tackling fraud:

The Association of Chartered Certified Accountants  
 The Tax Faculty of the Institute of Chartered Accountants in England and Wales  
 The Institute of Chartered Accountants of Scotland  
 The Chartered Institute of Taxation  
 The British Chambers of Commerce  
 The Institute of Directors  
 The Confederation of British Industry  
 The Federation of Small Businesses  
 The Law Society  
 The Law Society of Scotland

## External comparisons

- 8 In developing the study methodology, we also drew upon the practices of a range of other public and private sector organisations in the UK and overseas to identify further examples of good practice in tackling fraud. These included:

- Other government departments
- Firms and consultants in the private sector
- Supreme Audit Institutions
- Revenue agencies in Australia, Canada, The United States and New Zealand

## Assessment of joined-up action in tackling fraud

- 9 We employed Professor Michael Levi of Cardiff University and Professor Alan Doig of Teesside Business School to advise us on the effectiveness of the three Departments' involvement in joint action against fraud. They developed a set of questions on joint action for the study team to use, examined relevant information obtained by the National Audit Office and carried out interviews with the three Departments and a selection of other public and private sector organisations.

## Advisory Group

- 10 To cover all three fraud studies we set up two advisory groups to provide advice and feedback on the study plans, methodology, emerging findings and the draft reports. Membership of the groups was as follows:

### First Group (Public Sector)

John Alpass and Bernard Dixon - Department for Work and Pensions  
 Tony Walker - HM Customs and Excise  
 John Gilbody - Inland Revenue  
 Ken Farrow - Association of Chief Police Officers  
 Arwel Roberts - Audit Scotland  
 Andrew Laing - Crown Office and Procurator Fiscal Service (Scotland)  
 Liam Carroll - Crown Prosecution Service  
 Jim Gee and Maureen Phillips - Department of Health  
 Derek Elliott - District Audit  
 Vina Kapil - Home Office  
 Mike Holloway - Lord Chancellor's Department  
 Andy Blezzard - National Criminal Intelligence Service  
 Roddy Gillanders - Serious Fraud Office  
 Chris Butler - HM Treasury

### Second Group (External experts)

Ann Chandler - Adjudicator's Office  
 Liesel Annible - Association of Certified Fraud Examiners  
 John Wilkinson - Association for Payment Clearing Services  
 Graham Watson, David Lennox - British Bankers' Association, Fraud Prevention and Intelligence Unit  
 Professor Mike Levi - Cardiff University, White-Collar and Organised Crime Research Unit  
 Tim Crowley - Chartered Institute of Public Finance and Accountancy Anti-Fraud and Anti-Corruption Panel  
 Andrew P Wilson - Consignia  
 Spike Hughes - Counter Fraud Professional Accreditation Board  
 Brian Dille - Financial Services Authority  
 Martin Robinson - Institute of Chartered Accountants of England and Wales Fraud Advisory Panel  
 Mark Button - Institute of Criminal Justice Studies, University of Portsmouth  
 Mike Haley - Office of Fair Trading  
 Professor Alan Doig - University of Teesside, Teesside Business School, Fraud Management Studies Unit

# Appendix 2

## Key conclusions and recommendations on fraud measurement

### Consultant's objectives and methodology

- 1 We engaged Business Strategies, an economic consultancy firm, to review the methodologies used by the Inland Revenue, HM Customs and Excise and the Department for Work and Pensions in measuring and analysing fraud. The objectives of the assignment were to:
  - Review the overall robustness of methodologies for estimating fraud employed by the three Departments.
  - Determine the scope for improvement in departmental estimates and methods, including taking account of the impact of the shadow economy.
  - Identify any lessons or good practices from approaches adopted by other organisations and academics in the UK and internationally.
- 2 Business Strategies approach involved:
  - Reviewing documentary evidence on the Department's approaches.
  - Meeting with the main analytical and other staff responsible for designing and implementing departmental approaches to measurement.
  - Reviewing the literature on research by academics and others, including overseas authorities where available, on the measurement of fraud and the shadow economy.
  - Discussions with leading researchers, including a Canadian based academic who is an acknowledged expert on the shadow economy.

### Main findings on the Revenue

- 3 A copy of Business Strategies final report was provided to each of the Departments. The detailed report includes references to various recent research that the Departments may wish to consider in developing and refining their approaches. The following summarises their main findings on the Revenue.

#### On the shadow economy

- 4 Business Strategies concluded that to calculate the level of resources to apply to the prevention and reduction of non-compliance, it is necessary to know the cost to the nation. In order to determine the cost, it is necessary to estimate the size of the shadow economy. While acknowledging the difficulties in obtaining accurate estimates, Business Strategies view is that the cost of determining the extent and nature of the shadow economy is in most circumstances below the expected benefit. Against this, the Revenue do not believe that a coherent compliance strategy depends simply on an estimate of the size of the shadow economy. They see more value in obtaining information on the tax at risk within the shadow economy, as well as on who is committing the evasion and where it is occurring. Such information is useful in estimates on the level of recoverable tax, and improving decisions on resource allocation and understanding the effects of activities to tackle non-compliance.

- 5 The costs of the shadow economy might include:
- Information used as a basis for decision-making is distorted and misleading, for example, growth rates may be biased.
  - Activity in the shadow economy works against the equity aims of the tax system. The erosion of the tax base has to be recovered through more taxes elsewhere and/or reduced expenditure, in turn leading to reduced economic growth.
  - The need for higher taxes stemming from erosion of the tax base has implications for efficiency. Taxes interfere with market forces and a progressive taxation system can have disincentive effects, reducing labour and capital market efficiency.
  - The existence of shadow economy activity means that authorities must take preventative and curative action.
  - A distortion occurs in the resource costs in the expenditures made by the taxpayer to cover their tax deceptions. For example, the costs of offshore accounts and payments to unscrupulous professional advisers. The ease of evading taxes differs by, for instance, the type of employment. This could lead to a disproportionate amount of time spent in those areas where tax evasion is considered to be easier, for example, self-employment.
  - Tax evasion can undermine public confidence in the tax structure. The successful tax evader will have a higher post-tax income than an honest taxpayer with the same pre-tax income.
- 6 While the Revenue keep a watching brief on research into the UK shadow economy, they do not attempt to estimate the size of the shadow economy on the basis that:
- Estimates say nothing about the nature of the shadow activity and, in particular, very little about the tax gap, and aggregate measures provide no information on the income of individuals operating in the shadow economy and taxable activity.
  - Existing macroeconomic and microeconomic approaches contain questionable assumptions and none have provided a robust estimate of the scale of the UK shadow economy with significant variation between the available estimates.
  - A change in the monetary estimate may just imply an increase or decrease in the effectiveness of the technique used, as opposed to changing levels of tax evasion, and estimates give no information on where the growth areas are, and so are not thought relevant to policy or resource allocation.
- 7 Research work carried out in New Zealand and Canada has sought to address some of these problems and the Revenue should consider the merits of their application in the UK. For example:
- A study in New Zealand broke down the shadow economy into the 'hard-core' criminal component that is not responsive to changes in tax policy and the 'soft-core' component that is responsive<sup>9</sup>. The estimated split was around 50-50, which Business Strategies and the experts with whom they consulted considered fairly accurate for countries such as the UK. The division should not be interpreted in a literal sense, but it provides a way of estimating lower limits for the recoverable tax gap and could be explored by the Revenue. A comparison of movements in the estimated series to those from 'bottom-up' estimates, such as the random enquiry programmes, could also be a helpful indicator of the effectiveness of current policies and resource allocation. It may also provide a pointer to growth in non-compliance in areas that the Revenue are currently unaware of.
  - A study in Canada developed models that consider the impact on the size of the shadow economy of changes in aggregate effective taxes rates and the individual effective taxes rates of personal taxes, corporate taxes, indirect taxes and "other" taxes<sup>10</sup>. Business Strategies consider that in the event of changes (or proposed changes) in tax policy, similar results for the UK might help the Revenue to pinpoint where the growth in the shadow economy is likely to occur.

### On measurement techniques used by the Revenue

- 8 The Revenue are using or developing a range of techniques to measure compliance that fall under one of three categories:
- Audit-based studies - random enquiry programmes.
  - Modelling techniques where mathematical techniques are applied to compliance data to explain or predict taxpayer non-compliance.
  - Distinct datasets involving the comparison of compliance data and estimates of economic activity.

<sup>9</sup> Giles, David E.A., and Patrick Caragata (2001), "The Learning Path of the Hidden Economy: The Tax Burden and Tax Evasion in New Zealand", *Applied Economics*, Vol. 33, pp. 1857 - 1867.

<sup>10</sup> Giles, David EA and Patrick J. Caragata (2000), "Simulating the Relationship Between the Hidden Economy and the Tax Size and Tax Mix in New Zealand", in *Taxation and the Limits of Government* (Boston: Kluwer Academic publishers), pp. 243-269; and Giles, D.E.A. and L. Tedds (2002), "Taxes and the Canadian Underground Economy", *Canadian Tax Paper No. 106*, Canadian Tax Foundation, pp. 185-234.

- 9 The random enquiry programmes are a relatively new and useful development that enable the Revenue to provide estimates of non-compliance and facilitate research into understanding the risks of non-compliance in specific taxpayer and customer groups. The Revenue's approach is technically robust but:
- The sample size is constrained by cost and the taxpayer burden associated with enquiry.
  - The approach is new and only a few years data are available. This limits the ability of the Revenue to currently draw meaningful conclusions about trends.
  - Information obtained from the random enquiry programme is not broken down into that due to either fraud or error.
  - The random enquiry programmes are designed to estimate percentages of non-compliant taxpayers. Estimates of the tax at risk extrapolated from non-compliant cases are subject to higher degrees of uncertainty due to the significantly smaller sample of non-compliant customers and the skewed distribution of money evaded (a few non-payers account for most of the monetary value of tax at risk).
  - The random enquiry programme only covers registered taxpayers and therefore cannot, nor is designed to, detect all under-reporting.
- 10 The Revenue use robust modelling techniques to analyse data on non-compliance from the random enquiry programmes. The self assessed population are separated into homogeneous groups using cluster analysis, the results of which are fed into rule induction models to establish selection criteria for targeted enquiry programmes. The selection criteria are tested before full implementation by local tax offices. Further econometric analysis, drawing on recent academic research, is being piloted aimed at identifying the characteristics that are significant indicators of tax at risk of at least £500 in individual cases. The sample will also be split into homogeneous groups, and for companies additional yield will be modelled against net profits to further improve the identification of characteristics for targeting enquiry work. The Revenue appear to be as far forward in the practical application of these techniques as other overseas fiscal authorities.
- 11 The Revenue are starting to make good use of external sources of data to supplement their in-house sampling and modelling. In particular, the Revenue are usefully comparing:
- Corporation Tax Self Assessment payments with reported profits from externally available accounts, comparing like companies to identify irregular behaviour.
  - The results of the random enquiry programme with analysis of the Family Expenditure Survey. Econometric modelling of the Family Expenditure Survey allows the Revenue to infer unreported income from cases where spending on food seems high. The results have provided a useful cross check to confirm the results of the random enquiry programme, and have provided potentially useful information on the trades and professions where the risks of under-reporting may be greatest. The results compare well with similar academic research conducted in the UK and Canada.
- 12 The Revenue are currently exploring the use of the Labour Force Survey to provide better information on unreported activity. Assuming individuals will respond more honestly to the Labour Force Survey than to the Revenue, they are looking to estimate the numbers of people employed and hours worked and compare this to information reported on tax returns. The Revenue will be able to compare the Labour Force Survey data with large random samples from their taxpayer databases to help them identify discrepancies and previously unknown areas of under-reporting and to improve their understanding of the population operating in the shadow economy. The Revenue plan to extend this work by drawing on information held by the Department for Work and Pensions and the Home Office, as well as the growing intelligence on individuals and businesses operating in the shadow economy being identified by local tax offices.



## Recommendations for the Revenue

The consultant's recommendations for the Revenue were as follows:

### On the shadow economy

- While acknowledging that the usefulness of estimates of the shadow economy are limited by the assumptions underpinning them, such estimates are nonetheless worthwhile producing because they provide relevant information on the extent of shadow activity and how it is changing across time. Further, existing studies have shown they can be extended to provide more Revenue specific information. The Revenue should consider using the approaches in New Zealand and Canada referred to above to:
  - Estimate lower limits for the recoverable tax gap.
  - Compare movements in the series to those from existing bottom up approaches such as the random enquiry programmes.

### On measurement techniques used by the Revenue

- Information obtained from the random enquiry programme about non-compliance is not yet broken down into that due to fraud or error (official or customer). The Revenue should consider whether information from the random enquiry programme can be categorised more clearly as fraud or error. This may enhance the value of the information in determining the most appropriate operational response. It is however, acknowledged by fiscal authorities that this is difficult in relation to tax because it relies on a subjective judgement of taxpayer motivation.

- Despite the recognised difficulties in using the random enquiry results to generate estimates of the value of tax at risk, it is worth providing an estimate of the extent of the tax evaded (and the associated error margin) to give some idea of the scope of the problem. Because targeted enquiries are more frequent and have a higher hit rate the results might be used to get a better understanding of the shape of the income distribution of the non-compliant population. As the programme proceeds additional years data should enable reductions in margins of error. Further research could be done to see if the results of targeted enquiries can be used in statistical models to reduce uncertainty in estimates of tax at risk.
- The random enquiry programme is designed to give estimates of the proportions of non-compliant taxpayers. It only covers registered taxpayers, however, and will not find all under-reported income. The US Internal Revenue Service has attempted to estimate the extent of this under-recording across different groups of tax types and scales up the results of their taxpayer audits accordingly. The Revenue could consider an estimate on a similar basis of under-reported income by random assessment. It would also be interesting to see an assessment of what kind of income is at risk.
- A possible area for improvement in the use of Labour Force Survey (LFS) data might be to extend the investigation from employment data to LFS inactivity and unemployment data, and compare the results with the Department for Work and Pension's benefits analysis.
- In the USA there has been growing interest in the extent of tax evasion using offshore accounts and structures in the corporate sector. Research in the USA provides examples of the approaches the Revenue might pursue in order to gain a better understanding of the extent of use of offshore accounts<sup>11</sup>.

<sup>11</sup> Mills, L., Newberry, K. and Trautman, W.B. (2002), "Trends in book-tax income and balance sheet differences", paper presented at the 2002 IRS Research Conference, May 20, 2002.

# Appendix 3

## Examples of tax fraud using offshore accounts and structures

This appendix provides further information on two case examples, one on the use of offshore structures deliberately designed to evade tax (Case example L, paragraph 3.16), the other on non-disclosure of offshore transfers for the purpose

of committing tax fraud (Case example M, paragraph 3.18). These examples highlight the complexities and challenges faced by the Revenue in investigating and taking action on such frauds.

### EXPANDED CASE EXAMPLE L: Offshore structures designed to evade tax

In 1990, the Revenue received information from the District Valuer on substantial UK property dealings by two Jersey-based offshore companies. Initial research revealed the companies had never submitted tax returns and that the owner of a number of freight companies closely linked to them had not made tax returns for a number of years. The Revenue started a formal enquiry into the owner's affairs. He refused to co-operate, but third-party enquiries with banks, estate agents and solicitors revealed his links with the property dealings, a history of suspect freight company liquidations and Pay As You Earn failures, and the offshore diversion of profits from his UK freight companies. On this basis the Revenue started a civil investigation of serious tax fraud in October 1991.

The owner remained uncooperative, eventually providing a signed assets and liabilities statement showing minimal assets together with a formal denial of any substantial involvement in the offshore companies. He lodged an appeal against the Revenue's tax assessment with the Revenue's Special Commissioners. The appeal did not take place as new evidence emerged in a separate investigation into the activities of a Jersey based accountant suspected of assisting UK clients to evade tax and obtain offshore account-based credit cards. The accountant had obtained credit cards for the owner in the name of the two offshore companies. Despite being directly queried about credit cards when first interviewed, the owner had omitted their existence from his signed declaration. The credit cards recorded substantial private expenditure by the owner, and one of the credit cards was in the name of an offshore company that owned substantial UK property in which the owner and his family lived rent-free, allegedly as unpaid caretakers.

The investigation also revealed links to a solicitor who had assisted in purchasing property in the names of the offshore companies. Sufficient evidence now existed to suspect the individual of tax fraud and the accountant and the solicitor of assisting him. In early 1995 the investigation was upgraded to criminal status. With co-operation from the Jersey authorities, vital documentary evidence was obtained from the accountant's office proving that the owner controlled the Jersey companies from the UK and liability for Corporation Tax. A search of the solicitor's home uncovered an audiotape describing the offshore structure as one of the best he had seen. The offshore structure included: two discretionary trusts in Jersey holding share capital from his companies; settlers of trusts in Switzerland and Gibraltar; 13 offshore companies registered in Jersey and Liberia; and dozens of nominee directors located throughout Europe. The Revenue calculated that over 17 years £6.6 million of profits and £1.5 million of income and benefits chargeable for corporation and income tax had been deliberately concealed. He owed the Revenue £3.1 million.

The individual applied for a Judicial Review in May 1996 but his abuse of process claim was dismissed in the High Court in February 1997. In the meantime the accountant and the solicitor were found guilty and imprisoned for conspiracy to cheat the Revenue in respect of another UK taxpayer. During the nine-month delay, further evidence emerged against the owner proving subterfuge to cloak his control of the Jersey companies. He was rearrested in March 1997 and the Crown Court trial took place in January 1998. He was eventually found guilty, sentenced to seven years imprisonment and ordered to pay £3.1 million in confiscation. The sentence severity reflected both the scale of the fraud and the blatant lying during the civil investigation, and set a precedent for treatment of deliberate deceit by taxpayers. He unsuccessfully appealed against his sentence in the Court of Appeal in July 1999 and the House of Lords in October 2001.

## EXPANDED CASE EXAMPLE M: Tax fraud involving systematic concealment of offshore transfers

Since 1985 the Revenue had been concerned about the use of a sundry parties' account by a bank to transfer customers' monies to the Isle of Man. Banks normally use sundry parties' accounts for isolated local branch transactions that do not involve customers who have a current account. At that time the Revenue had insufficient knowledge about how the account operated, nor sufficient information gathering powers to investigate the matter. A report in March 1986 by the bank's auditors concluded that there was no systematic transfer of funds to the Isle of Man. The Revenue issued returns requesting information about offshore interest paid through the bank's sundry parties' account. The bank, however, were concerned about their customers' entitlement to have their financial affairs kept confidential. An agreement was reached in 1991 whereby the bank was released from the obligation to comply with the Revenue's request in return for not passing any further transactions through the account. During the proceedings the bank issued a report revealing that the account had been used by one branch to transfer funds to the Isle of Man, but concluded that the bank's accounting treatment was appropriate. The Chief Inspector of the Bank confirmed that the transfers were typical of the use to which the account was put in all branches.

In late 1992 the director of a close company was investigated following receipt of information that he had undeclared funds invested in the Isle of Man. The director provided details of the funds and a report indicating he also transferred money through his branch of the bank to one of its subsidiaries in the Isle of Man. The Revenue requested evidence of the transactions from the director's UK based branch of the bank. The bank supplied documents detailing transactions from the named customer's accounts as well as transactions through an internal sundry parties' account. Other cases revealed other bank customers using the sundry parties' account to transfer undeclared profits to the Isle of Man. The Revenue now had evidence that the bank's sundry parties' account was being used by customers to conceal transfers offshore for substantial and systematic tax evasion and in October 1994 again requested information about the account. The bank declined the request on the grounds that the 1991 agreement precluded the Revenue from enquiring again and because of their legal obligation to preserve customer confidentiality. The Revenue gave notice in August 1995 of its intention to apply under Section 20(8A) of the Taxes Management Act 1970, for full disclosure of all transactions through the sundry parties' accounts from 1979 to 1991, but limited to six branches to test the validity of the Revenue's suspicions. After a judicial review the Court of Appeal rejected the bank's arguments including that the cost of complying with the Notice was onerous, and the bank complied with a Section 20(8A) notice in November 1998.

By March 1999 the Revenue had identified 51 new cases of undeclared taxable assets concealed in offshore accounts, and issued another notice covering all the remaining branches. The bank again obtained a judicial review this time on technical grounds, but in June 2000 the High Court found in favour of the Revenue. The bank promptly supplied some 38,000 original hard copy bank statements showing all transactions in all branches' 'sundry parties' accounts between 1979 and 1991. Following discussions the Revenue reached an agreement with the bank that limited the number of transactions for which customer identification was needed whilst at the same time ensuring that it received sufficient information to carry out its enquiries. Examination of the statements identified transactions involving potential tax fraud that the Revenue estimates may lead to a total recovery of £90 million of tax, interest and penalties (averaging £200,000 per case). The first 51 cases have been completed via negotiated settlement in which prosecution was waived in the light of the co-operation provided, leading to recovery of £5.1 million in tax and a further £5.1 million in penalties and interest. This was the first time the Revenue had been able to examine the internal workings of a bank. Local branches operated with a high degree of autonomy in managing the services offered to their local clients. Under these conditions the use of sundry parties' accounts to transfer clients' monies to offshore accounts had grown, not only to the Isle of Man, but also the Channel Islands and the Republic of Ireland.

In June 2001, six investigators were tasked to complete the work on the first six branches and the new data from all the remaining branches liaising with local tax offices. As at March 2002 45 cases were ongoing. In September 2002 the team was increased to 11 and will take around five years to complete the estimated remaining 400 cases.