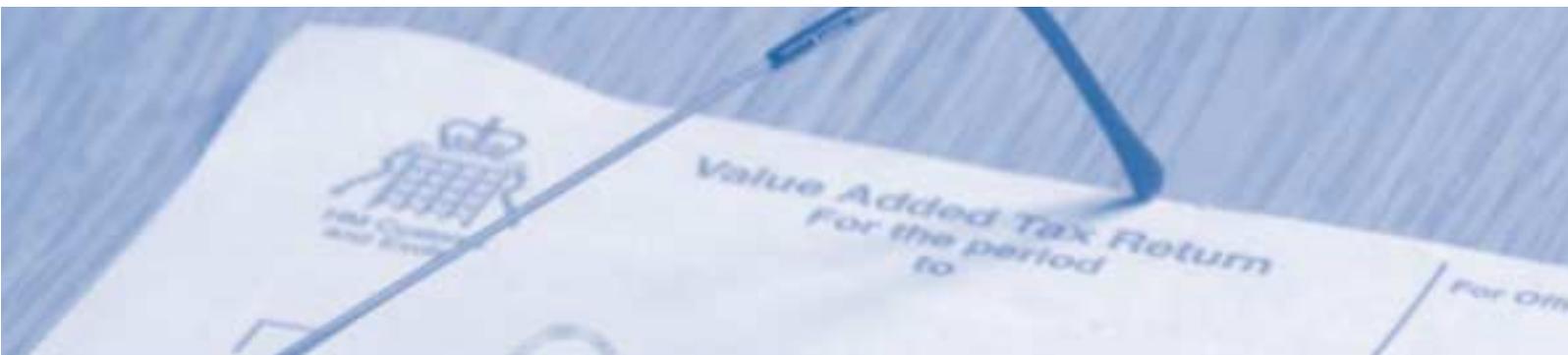


HM Customs and Excise Tackling VAT Fraud

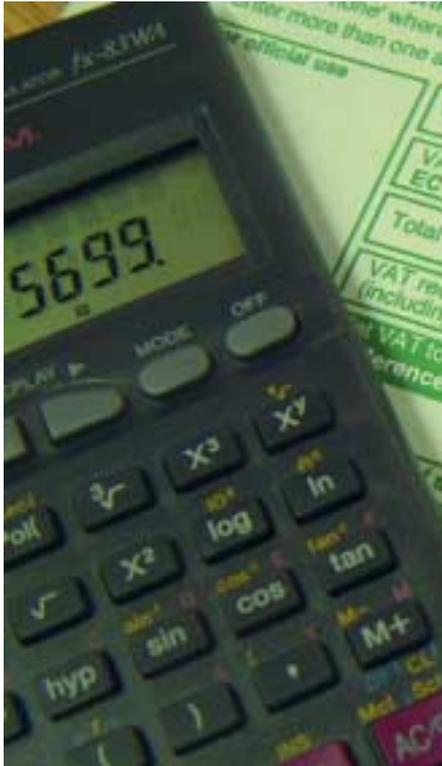


REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 357 Session 2003-2004: 3 March 2004

executive summary



- 1 Value Added Tax (VAT) is a self assessed tax on the supply of goods and services, introduced in the UK in 1973. It is collected by 1.7 million registered traders and paid over to Customs. In 2002-03 Customs collected net VAT receipts of £63.6 billion, made up of just over £108.8 billion in receipts of which £45.2 billion was repaid to businesses that had paid more VAT on purchases than they had collected on sales and could reclaim the difference. Traders may not pay the correct amount of VAT for a number of reasons including error, deliberately understating their VAT liabilities or through systematic attacks on the VAT system. Customs estimate that the amount lost on VAT could be around £11.9 billion in 2002-03, which includes substantial non-fraud losses. The Government has set Customs a target to stop the long-term growth in the size of the overall VAT gap and to cut it from 15.7 per cent in 2002-03 to 12 per cent of the total amount that could be theoretically collected from VAT by 2005-06. This report examines Customs' approach to:
 - detecting, investigating and preventing VAT fraud (Part 2);
 - tackling the most serious type of VAT fraud known as VAT missing trader intra-Community fraud where bogus traders register for VAT, buy goods VAT free from another EU Member State, sell them on at VAT inclusive prices and then disappear without paying over to Customs the VAT they have collected (Part 3);
 - those traders operating in the shadow economy who fail to register to pay VAT (Part 4).
- 2 On VAT missing trader fraud, Customs estimate that losses amounted to £1.65 billion to £2.64 billion in 2002-03 which was a reduction on the previous year. They became concerned about this type of fraud in late 1999 and in September 2000 introduced measures to tackle it. Customs published details of additional steps being taken to tackle this fraud in November 2002 and April 2003. On the shadow economy, Customs estimated the losses to be £400 million to £500 million in 2001-02 (the latest figures available).
- 3 To evaluate Customs' methodology for measuring fraud and error, we employed specialist economic and risk management consultants. We interviewed staff at locations around the UK and analysed operational data to establish how Customs prevent, detect and investigate fraud. We spoke to a number of organisations and individuals in the public and private sector and overseas to identify examples of good practice in tackling fraud. Our work helped us to assess whether Customs' approach matched best practices and identify where improvements could be made. Our methodology is set out in Appendix 1.



Estimating the VAT losses

- 4 Customs have done well to estimate the scale of losses on VAT and are leaders in Europe in this type of work. They have determined how they need to respond to the problem, the resources needed and set targets for reducing the loss. Customs' estimates are necessarily subject to a margin of error because of the number of assumptions made and the reliability of the data used. Research by our consultants established that Customs have used appropriate methods to estimate the VAT losses and have made the best use of the data available, even though these are subject to uncertainty. Customs have estimated the trends in losses for VAT missing trader fraud and are carrying out further work on estimating other losses to determine whether their response is proportionate to the risks.

Preventing Fraud

- 5 Customs are giving increased emphasis to helping traders comply with their VAT obligations by improving guidance and support and offering solutions to businesses which have problems. For example Customs have produced a range of guidance for new businesses on their responsibilities including some in cooperation with other government departments and trade bodies. Such information can be important to businesses operating in the shadow economy which may not fully understand the requirements to register with Customs where their turnover exceeds £56,000 a year.
- 6 Fraud comes in many guises from traders from omitting the occasional sale from their records to systematic suppression of sales or falsification of purchase invoices. Other fraudsters may have little or no legitimate business activity and register with Customs for the purpose of stealing VAT. An example of this is missing trader intra-Community fraud where fraudsters pose as genuine traders to purchase goods VAT free in other Member States, sell on at a paper loss and then disappear without paying to Customs the VAT collected on sales. Customs are seeking to prevent potential missing trader fraudsters from registering with them. In 2002-03 Customs' checks on new registration applications led to 914 suspect applications being refused or around 0.35 per cent of those applying to register. They also attached conditions to many other registrations (such as requiring the trader to provide financial security) because of concerns about possible fraud.
- 7 In the European Commission's view, a fundamentally different system to the way in which VAT is administered in respect of Intra-Community transactions would help amongst other things to tackle missing trader fraud. The alternative system would involve traders paying VAT in the Member States where the goods are produced, known as taxation in the place of origin. The Commission considers that the scope for the current type of missing trader intra-Community fraud would be reduced as goods would no longer be traded VAT free between States. However, taxation at the point of consumption (the current system) is a widely accepted principle within the EU and it is unlikely that political agreement would be reached on any changes, especially as it is generally accepted that the alternative system may require closer harmonisation of VAT rates with implications for products and services which the UK currently zero rates. Although the incidence of this type of missing trader fraud might be reduced such a change would result in an increase in other types of fraud such as repayment frauds using false invoices. The alternative system is not viewed as a practical option at the present time and it is not the responsibility of Customs to take forward. Customs and some other Member States have therefore developed their own approach to tackling missing trader fraud. Customs have also worked with the European Commission and some other Member States to develop good practice guidelines for tackling it.

Detecting non-compliance and fraud

- 8 To tackle non-compliance in the general trader population Customs audit the systems of the largest traders and select other traders for audit based on risk criteria. Their experience shows that around a third of traders under-declare their VAT liability for a variety of reasons and in 2002-03 their checks identified an additional liability of over £3 billion from their targeted visits. Customs have found that distinguishing between what is error and what is fraud is often not possible because of the difficulties in proving the intention of the traders. The thrust of their approach therefore is to deliver year on year improvements in the compliance of businesses with their obligations and maximising the yield.
- 9 Customs' Intelligence staff have an important role in establishing patterns of non-compliance and targeting activity at the high risk sectors of the economy. Since September 2002 Customs have been improving their approach to intelligence work by focusing on national, regional and local risks rather than individual leads. They also expect the introduction of e-Business applications across their operations by 2005 to help generate summarised real time information which will help them assess the risks to VAT revenue more accurately and quickly. In deciding on the resources to be allocated, Customs regularly review the risks to ensure these are focused on the priority areas set out in their strategies. In 2002-03 Customs allocated 13 per cent of their Intelligence resources on VAT work down from 16 per cent in the previous year. This was mainly because some Intelligence staff were redeployed onto higher yielding revenue work and improvements were made in the way staff are used on VAT work.
- 10 Some businesses operating in the shadow economy take deliberate steps to avoid registration by suppressing their declared turnover or fragment their businesses into separate units to show a turnover below the VAT registration threshold of £56,000 a year for each business. Some may also not realise that they need to register. Customs estimate they may be losing £400 million to £500 million a year from between 125,000 and 180,000 traders operating in the shadow economy who have not registered for VAT at around £3,000 to £4,000 in VAT for each trader. By working closely with the Inland Revenue and Department for Work and Pensions, Customs have detected almost 4,000 traders a year who should be registered, or around 3 per cent of the total estimated to be operating in the shadow economy. They get a good return on this work of around £16 for every £1 spent and are allocating more resources to detecting traders that should be registered. The work however is resource intensive because of the high turnover of businesses operating in the shadow economy.
- 11 In Budget 2003 the Government announced a one-off incentive scheme which ran from 10 April to 30 September 2003 for businesses which should have previously registered for VAT, but had not. These businesses would not incur penalties for late registration if they came forward voluntarily, assisted in establishing the amount of VAT due and paid any arrears in full and furnished all VAT returns and payments on time for 12 months after registration. By the end of December 2003, almost 3,900 applications for late registration had been processed under the scheme involving arrears in the region of £26 million. To help identify those who continue to operate in the shadow economy, Customs are taking forward an exercise to match selected Inland Revenue data with their own database of traders.



- 12** Customs make good use of information from a number of different sources to help them detect VAT missing trader fraud. One source of information is the notifications of suspicious transactions by financial institutions made to the National Criminal Intelligence Service which, over the last few years, have worked on increasing the numbers of notifications made. Another is a European Union information system which can detect possible intra-Community VAT frauds known as the VAT Information Exchange System or VIES (a computerised system for automatically exchanging information about VAT registered taxpayers and the value of their intra-Community supplies of goods). On the VIES, data on transactions can be at least three months old, and some traders do not record transactions or they record them incorrectly. With the support of Customs, the European Commission have been working on proposals to improve and strengthen administrative cooperation between tax authorities to tackle this type of fraud which are expected to come into force in 2004. Customs have also developed bilateral agreements directly with eight Member States and three other agreements are being pursued which will allow information to be exchanged more rapidly and which will help to identify fraudsters.
- 13** Where Customs detect a missing trader they will deregister the company to stop it trading, raise assessments for the amount of VAT owed, where possible obtain freezing orders on the company's bank accounts, and prosecute those involved where appropriate. During 2002-03 Customs also disallowed £63 million of VAT repayments to exporters suspected of being part of a supply chain where VAT had gone missing from carousel fraud (a type of missing trader fraud). In Budget 2003 further measures were announced to help Customs deal with companies who might be part of a missing trader supply chain, such as making a business jointly and severally liable for VAT unpaid on sales of mobile phones and computer components.

Investigations and Sanctions

- 14** Customs seek first to stop VAT frauds at the earliest opportunity to prevent any further losses, and second to impose a civil evasion penalty or prosecute those involved. Decisions on actions to be taken depend on whether the case falls within Customs' criteria on prosecutions (such as whether the business was set up with the intention to carry out fraud, the occurrence of other criminal activities, or whether lawyers, accountants and others who advise on VAT matters are involved), the available evidence, and the likelihood of evidence being obtained from another source or through investigation. Customs also seek to collect arrears to ensure that the economics of the crime are attacked and that penalties act as a deterrent.
- 15** Where VAT fraud is suspected, Customs look wherever possible to impose a civil evasion penalty which can be up to 100 per cent of the amount evaded. Customs generally only investigate with a view to criminal prosecution, the more serious or aggravated cases. For example, where the fraud involves the registration of one or more businesses whose activities are solely or primarily bogus, or the carrying out of systematic fraud against the VAT system. In September 2000, Customs introduced a strategy to tackle VAT missing trader fraud and, as part of this, reallocated investigation resources from less serious VAT cases to those involving missing trader fraud. Customs also began to target other more complex and larger value cases using their civil evasion procedures.
- 16** The number of finalised cases where civil evasion penalties have been imposed has fallen from 898 in 1997-98 to 276 cases in 2002-03 but the average value of each case has risen. In these cases Customs identified VAT evaded of around £27 million or around £30,000 a case in 1997-98 and in 2002-03 £16 million and around £59,000 a case. In April 2002 Customs introduced a new approach to tackling some VAT fraud cases which seeks to reach agreement with traders on the nature, extent and reason for irregularities. The indications are that the elapsed time to complete cases under the new civil evasion procedures is quicker at an average of nearly seven months compared with 11 months for those completed under the standard civil evasion procedures. Payment of arrears has also been more prompt and Customs case handling capacity has increased.

- 17 The number of VAT prosecutions finalised in courts has remained broadly constant in recent years at around 90 a year. Customs now concentrate on bringing to trial the more serious cases, such as missing trader frauds, where the amount of VAT lost can be considerable. Customs are currently working on around 100 ongoing missing trader fraud criminal cases involving VAT totalling some £2 billion, with over 80 of these cases awaiting trial. Of the 86 VAT fraud cases finalised in court in 2002-03, 69 resulted in convictions of which seven were for missing trader fraud. VAT fraud cases successfully prosecuted took on average two years and eight months to complete (including investigation and prosecution), with some taking over five years. The complexity of the cases has been an important factor in the time taken involving issues such as the number of defendants involved and the need to carry out the investigations in other jurisdictions, particularly for VAT missing trader fraud. The availability of court time can also delay a case. Early pleas of guilty could help to reduce the time taken on a case, especially where there are lengthy waiting times before the trial but there is little incentive in terms of reduced sentence to encourage such pleas before the trial and some defendants will wait until the early stages of the trial to enter a guilty plea.
- 18 The Butterfield report, published in July 2003, found that the basic training given to investigators is reasonably thorough but that subsequent training is somewhat ad hoc and not systematic and recommended that improvements should be made. Customs are continually developing the training of their investigators such as on the handling of informants and the disclosure of unused material on a case and supplement their training with instructions and guidance on investigative procedures and the law. Customs are now in the process of introducing national standards that will form the basis for future training in common with other Law Enforcement Agencies and in partnership with the Police Skills and Standards Organisation. The Butterfield report also recommended that Customs' Prosecutions Office should become independent. It concluded that, although over the last few years there had been considerable changes to the independence of the prosecuting lawyers in Customs, these changes had not gone far enough. Customs' lawyers needed to be in a position to exercise their "minister of justice" role without fear or favour and needed to be seen by others as in a position to do so. The Government has announced that an independent Customs and Excise Prosecutions Office will be set up during 2004 which will be directly accountable to the Attorney General.
- 19 Where Customs have prosecuted fraudsters they seek to recover the proceeds or benefit of the criminal activity through the use of confiscation orders. These orders can be a powerful deterrent to fraudsters as they tackle the economics of the crime. The enforcement of a confiscation order involves complex legal processes which, up to the end of December 2002, were managed exclusively by Customs' Asset Forfeiture Unit. At that time the Unit were handling around 330 confiscation orders with a value of £59 million. From December 2002 cases have been passed to a Task Force set up by the Home Office which enforces confiscation orders (whether obtained by Customs or by the Crown Prosecution Service). It can take many years to recover the assets. For example the courts may give the convicted person up to 5 years to pay, or there may be refusals to pay and Customs will monitor the case to see whether there are assets which can be realised to satisfy the confiscation order.
- 20 From February 2003, the newly created Assets Recovery Agency has been taking on cases from Customs and other agencies for civil recovery of assets where a criminal investigation has been carried out but it has proved impossible to continue with the criminal case and consequently there is no possibility of obtaining a confiscation order (which is dependent on conviction). The new civil recovery scheme enables the Director of the Assets Recovery Agency to take proceedings in the High Court for the recovery of the proceeds of unlawful conduct without the need for anybody to have been convicted of an offence. The Agency also has the option to tax the proceeds of crime where there are reasonable grounds to suspect that a person's income, profit or gain was obtained from crime.

Recommendations

On estimating VAT losses

- 21** Customs have made major strides forward in estimating the amount lost from VAT and over time this will allow them to assess trends. They have also produced estimates for specific types of loss that make up the total including the amount lost from VAT missing trader fraud and from failure by traders to register for VAT. Their estimates of losses from general non-compliance by registered traders is the largest area of losses ranging from £2.5 billion to £4 billion in 2001-02. Customs have not broken down these losses between those which are due to fraud and those which are due to error because of the subjective judgements that would need to be made on the intention of traders and the disproportionate resource Customs consider this would involve. If they could make the distinction between fraud and error then Customs would be able to assess whether the balance of their effort and the type of measures taken are appropriate. Against this background Customs should develop methods for estimating the amounts of fraud and error in the registered trader population.

On detecting fraud

- 22** Customs cooperate closely with other EU Member States to tackle VAT missing trader fraud. One mechanism which facilitates this is a computerised system for automatically exchanging information about VAT registered traders and the value of their intra-Community supplies of goods (known as the VAT Information Exchange System, or VIES). The value of VIES in tackling missing trader fraud can be limited as the data on the transactions will always be at least three months old, and some traders do not record transactions on the system or they record them incorrectly. Customs should continue to work with the European Commission to improve the quality of information used to detect irregularities by addressing the current weaknesses in VIES and related systems.

On investigations and sanctions

- 23** The number of cases where civil evasion penalties is imposed has fallen significantly although the average value of each case rose reflecting the targeting of more serious cases. The reduction in cases reflects the reallocation of staff to more serious criminal investigations where Customs will either prosecute a case, disrupt the fraud or dismantle the organised crime groups involved depending on the circumstances. Deciding on the balance between the different measures available requires difficult judgements on which combination is likely to have the best effect in deterring fraud. As part of their evaluation process, Customs should therefore assess whether they have the right balance of measures in place to reduce the VAT gap in line with the targets set by the Government.

- 24 In some cases, due to circumstances outside of their control, Customs may have to wait for up to a year for court time and lawyers to become available to try a complex case. Customs should assess with the Department for Constitutional Affairs whether there are opportunities to reduce the long wait for court time to become available in some VAT cases.
- 25 The new powers in the Proceeds of Crime Act 2002 which will allow Customs to seize cash should lead to criminal groups taking greater care in taking cash out of the banking system in the UK. Criminal groups may also intermingle legitimate and criminal funds through established businesses to confuse the audit trail and may place more assets overseas. Customs should identify how fraudsters are concealing their assets in these ways and how such devices can be countered by drawing on other countries' experiences. They should also work closely with the Assets Recovery Agency to uncover and realise hidden assets.
- 26 In response to the recommendations in the Butterfield report Customs are looking to improve the training provided to investigators. As part of this work Customs should raise the professionalism and standing of investigators by providing training to accredited professional standards.

On disseminating lessons learned

- 27 To encourage traders operating in the shadow economy to voluntarily register for VAT Customs introduced a one-off incentive scheme where they will not impose a penalty if the trader paid arrears of VAT in full and furnished returns on time for 12 months. There have been concerns that schemes of this type could be unfair to honest traders. To help other Departments assess the value of similar schemes, Customs should disseminate the lessons learned from the one-off incentive scheme.