

HM Customs and Excise
Losses to the Revenue
from Frauds on Alcohol Duty



REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 178 Session 2001-2002: 19 July 2001

executive summary

All taxes are subject to the risk of fraud and evasion

- 1 This Report examines the circumstances surrounding the known losses between 1993 and 2000, which were subject to Customs investigations, of alcohol duty worth £668 million from diversion onto UK markets, following the introduction of the Single European Market in 1993. Another £216 million was accounted for as revenue lost resulting from diversion onto overseas markets where duty would have been due in the country of import had the goods not been fraudulently diverted.
- 2 All taxes are subject to the risk of fraud and evasion, including smuggling. Given the need to balance countermeasures with the need for goods to flow freely, total prevention is not realistic and some loss is inevitable. There are no reliable estimates of the total level of loss from outward diversion fraud. Nevertheless, to tackle fraud, Customs seek to allocate their resources based on broad assessments of the risks. At the present time Customs see their highest fraud priority as tackling cigarette smuggling (where the published loss for 2000-01 was £2.9 billion).

In 1993 the Single European Market simplified the movement of goods to make trade easier, but unintentionally led to an increase in excise fraud

- 3 The creation of the Single European Market in 1993 brought with it the removal of restrictions on the movement of goods between European Union Member States, with the aim of making trade easier. Among other things, the Single Market led to changes in the system for the movement of excise goods under duty suspension between authorised warehouses or traders in the European Union. Decisions on the controls needed in each country over the simplified system for commercial movements of excise goods were left to individual Member States. In the United Kingdom, Customs adopted a risk-based approach, removing many of their physical checks of goods and largely passing operational control over the system to the traders themselves.
- 4 Before 1993 traders were required to declare to Customs all excise goods destined for export and make them available for pre-export examination. Customs staff also visited the excise warehouses regularly to carry out physical checks. The abolition of internal border controls from 1993, and the continued removal of regular physical checks, led to the growth of excise fraud. Criminals acquired increasingly large consignments of alcohol intended for export and illegally diverted them on to the UK market without payment of excise duty or VAT (known as outward diversion fraud). A chronology of events showing how frauds grew following the creation of the Single Market in 1993, and Customs response, is set out in the Annex to this Summary.
- 5 In February 1994, the Committee of Public Accounts, following up the Comptroller and Auditor General's report on the Department's 1992-93 accounts, asked Customs whether there was any sign of increased fraud as a result of the Single Market arrangements. Customs responded that they had,

from the outset of the Single Market, recognised that the changes would give rise to new risks of fraud and that there would be people eager to exploit these opportunities. Customs added that they were watching very carefully for fraud arising, but that, at that time, there was no sign of increased fraud as a result of the new Single Market arrangements. Appendix A sets out extracts from reports by the Comptroller and Auditor General and the Committee of Public Accounts on the risks of fraud, including diversion fraud, and Customs' responses, following the introduction of the Single Market in 1993.

Definitions

The Duty Suspension System - Under the Single Market, Member States are required to operate a system of duty suspension in order to facilitate alcohol trade. The system allows registered traders or warehousekeepers to produce, process, store and move goods without payment of duty. The system enables traders to time the payment of the duty due nearer to the time when they will sell on their goods. Duty becomes payable when the goods are released for consumption or are acquired by an unregistered individual.

An excise warehouse is one approved by Customs (under the Customs and Excise Management Act 1979 or the Alcoholic Liquor Duties Act 1979) for the storage of goods without payment of excise duty (i.e. duty is held "in suspense"). Customs have approved about 1,100 excise warehouses in the UK.

Duty suspended revenue goods are goods, such as alcohol and tobacco, where the payment of duty is postponed until they are released onto the UK market for consumption.

Outward excise diversion frauds are committed when duty suspended goods destined for export, or for another UK excise warehouse, are illegally diverted from an excise warehouse on to home or overseas markets, without payment of duty.

Inward diversion frauds are committed when duty suspended goods imported to an excise warehouse are illegally diverted on to the UK market, without payment of duty.

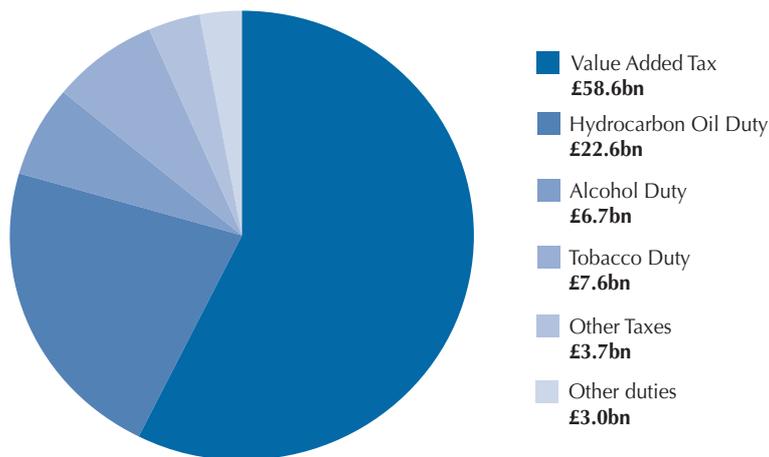
Revenue losses arise in cases where Customs raise an assessment for duty on a trader or an individual but the amounts cannot, or will not, be collected by Customs. The losses are calculated by totalling the revenue evaded and then deducting any cash subsequently collected or expected to be collected. The losses include excise duty and VAT. The average amount of duty lost on a diverted consignment of spirits (a 40 foot trailer load) is approximately £100,000, and on a similar consignment of high strength beer about £20,000.

Frauds between 1993 and 2000 led to alcohol duty evasion of £668 million from diversion onto UK markets, and another £216 million was accounted for as revenue lost from diversion onto overseas markets

- 6 By 1995, Customs became aware that the scale of alcohol diversion fraud was growing and by 1996 the recorded losses were significant. Customs' National Investigation Service recognised the emerging scale of diversion fraud, mainly through uncovering and investigating large fraud cases. The first investigation of UK diversion fraud was in August 1995. This fraud evaded revenue worth £19 million. In view of the seriousness of the trends, a briefing was given to the Customs Chairman in December 1995. In the event, estimates prepared by Customs in 2000 show that revenue evasion identified by investigations of alcohol diversion fraud grew rapidly from 1995-96 (see Figure 4 in Part 1).

- 7 Although large in themselves, the level of known losses from diversion fraud represent a small proportion of total revenue from alcohol duty. In 2000-01 HM Customs and Excise collected £6.7 billion from duty on alcohol, 6.6 per cent of the total revenue collected by the Department (**Figure 1**). Alcohol diversion duty losses identified from investigations between 1993-94 and 1999-00 represent some 1.4 per cent of the total revenue from alcohol duty over that period. The total level of loss from outward diversion fraud over the period is not known.

1 Alcohol duty formed 6.6 per cent of total revenue collected by HM Customs & Excise in 2000-01 (unaudited)



Customs short term response to diversion fraud was to protect the revenue by investigating cases with the aim of convicting the perpetrators

- 8 A key approach of the National Investigation Service to tackle diversion frauds was to protect the revenue by identifying the principals behind the fraud and collecting sufficient evidence to secure their conviction. The main method of achieving this was identifying suspect consignments and allowing fraudsters to move goods from excise warehouses whilst under observation (known as "letting loads run"). Selected consignments would be followed and when enough evidence was obtained the perpetrators would be arrested. An unavoidable consequence of this method was that arrears of duty would build up during the course of the investigation. The National Investigation Service considered that "letting loads run" was justifiable if it led to successful prosecutions and arrears of duty were recovered through confiscation orders from the Courts.
- 9 Even with the benefit of hindsight, it is difficult to determine whether a policy of greater disruption of alcohol diversion frauds between 1995 and 1998 would have led to a lower level of revenue losses. Customs investigators at the time found that where suspect consignments were intercepted at an early stage to disrupt fraudulent operations, fraudsters just moved to another warehouse to commit further frauds. And if a consignment under surveillance was stored for a period within the time limits for export, Customs did not have any legal power to disrupt the activity.
- 10 The Department identified around 130 cases of outward excise diversion fraud between 1994 and 1998. Over 100 successful prosecutions were made, a total of over 200 years in sentences were passed on those involved in the frauds and the Courts confiscated more than £23 million.

Over the longer term, Customs sought to tighten the controls over the duty suspension system

11 The identified losses of revenue arose mainly because fraudsters were able to take advantage of weak controls over the movement of alcohol to and from excise warehouses. The National Audit Office issued a report to Customs in July 1996 on controlling excise and inland Customs traders. The report highlighted the risks to the revenue from Customs' approach to handling traders and excise warehouses and was followed up in our Reports on the Department's 1996-97 and 1997-98 Accounts (see Appendix A). A Customs Internal Audit Report of April 1996 also highlighted the weaknesses in the movement system and the increased numbers of fraud cases. The weaknesses in the warehousing controls included:

- the difficulty of detecting fraudulent export documents;
- the reduced level of Customs' checks of excise warehouses, brought in following the Single Market;
- incomplete records of the movement of duty suspended goods;
- non-compliance with regulations by traders;
- failure to impose appropriate sanctions (such as deciding whether to invoke guarantees against losses).

12 In response to management concerns and the reports from the National Audit Office and Internal Audit, Customs took action to strengthen controls to tighten up the weaknesses in the system. The level of alcohol diversion fraud fell significantly after 1997-98 (see Figure 4 in Part 1). Examples of the measures taken include:

- targeting consignments diverted onto the home market in order to disrupt fraudulent activities (from 1996-97);
- encouraging warehousekeepers to obtain guarantees from the owners of the goods or hauliers;
- requiring warehousekeepers and the owners of goods to be registered;
- taking part in an European Union wide Early Warning System for certain consignments of spirits and cigarettes from warehouses.

13 In 1997 Ministers commissioned a review to look at the effect of alcohol and tobacco fraud, smuggling and cross-border shopping on the Exchequer and on industry revenue. The report of the Alcohol and Tobacco Fraud Review made some 90 recommendations, 31 of which related primarily to diversion fraud (Appendix B). Customs state they have implemented 18 of these recommendations (although six of these require further action by the European Union pending computerisation). Areas where further work is still needed relate primarily to reforms to the European Union-wide System for the Exchange of Excise Data (which stores the names of approved warehouses), recording of vehicle registration numbers, unique numbering of duty suspension movement records, marking of products and measures aimed at wholesale and cash and carry outlets.

Concerns about Customs' handling of the evasion of alcohol duty led to an independent enquiry

- 14** Customs' Chairman commissioned an internal review of the handling of the alcohol duty losses which reported in May 2000. The review highlighted the serious weaknesses in the Department's control of excise duty collection, in particular the mechanisms for releasing dutiable spirits and wine from excise warehouses. The review concluded that there had been significant revenue losses, principally in the three years after 1995.
- 15** Customs' Chairman reported the results of the review to the Paymaster General, Dawn Primarolo, in June 2000. Following this, the Paymaster General commissioned an independent investigation, headed by John Roques, an ex senior partner of Deloitte and Touche, to look into the matter. Mr Roques presented his report to Ministers on 15 December 2000. It contained 65 recommendations to improve controls and the way that fraud is tackled in Customs. The recommendations of the Roques report and the Paymaster General's announcement are set out at Appendices C and D respectively.
- 16** Customs fully or partially accept 62 of the 65 recommendations made by Roques. Two recommendations are under consideration and one cannot be implemented because it breaches European Union legislation (details of recommendations accepted are in Appendix C). Key measures being taken include:
- a more rigorous approach to the approval of warehouses;
 - tightening the registration procedures for warehousekeepers and the owners of goods;
 - improving the information on the holding and movement of excise goods where the duty has not been paid;
 - improving the exchange of information with other European Union Member States;
 - increasing the checks on warehousekeepers' compliance with holding and movement regulations;
 - tightening controls on hauliers;
 - considering the use of fiscal marks on alcohol.
- 17** Some 42 of the recommendations had been implemented by July 2001 (details of the implementation of recommendations are in Appendix C). Implementation of the rest will take some time to achieve. For example, the timetable for the introduction of a single, monthly, mandatory legal declaration by warehousekeepers to replace the current series of forms has not yet been decided (Appendix C, Recommendation 11). Inspection visits to all Registered Excise Dealers and Shippers traders will not be completed until July 2002 (Appendix C, Recommendation 17). On the introduction of fiscal marking, no timetable has yet been set (Appendix C, Recommendation 27). Customs expect to launch a real time information management system for investigation cases by March 2003 (Appendix C, Recommendation 39).

We have examined the actions taken and planned by Customs to deal with the threat of fraud

18 We reported on the identified losses to the revenue from excise diversion frauds in our annual report of 2001 on Customs accounts of revenue (Appropriation Accounts 1999-2000, Volume 16, Class XVI Departments of the Chancellor of the Exchequer, Chapter 5). In that report, we undertook to report again to Parliament once we had received all the evidence on the causes and lessons to be learned in this case.

19 Against this background we examined:

- How the frauds were undertaken and the action taken or planned to strengthen controls (Part 1).
- How Customs investigated the frauds and the action taken or planned to strengthen controls over future investigations (Part 2).
- The steps taken or planned by Customs to strengthen their general approach to tackling diversion fraud (Part 3).

20 In undertaking this work we:

- reviewed Customs' own internal reviews on the identified revenue losses from excise diversion fraud and the findings of the Roques report;
- examined Customs' action plans in response to these reviews;
- interviewed officials within Customs, both in post and retired, who dealt with this matter; and
- reviewed relevant previous recommendations by the Committee of Public Accounts since 1993 (Appendix A).

21 We are looking separately at the way that Customs are addressing the risks of fraud and evasion in other taxes and duties:

- in our report on hydrocarbon oil duty fraud, smuggling and the illegal use of rebated fuel, due for publication later this year;
- by covering Customs' systems and procedures on VAT registration and to ensure the payment of tobacco duty in the C&AG's Standard Report to be published later this year;
- through a wide-ranging review of the way that Customs, the Inland Revenue, the Department for Work and Pensions and the National Health Service tackle the major threat of fraud against the public purse.

Overall conclusion

- 22 Given the need to balance countermeasures with the need for goods to flow freely, there is always likely to be some revenue evasion. The loosening of controls that followed the introduction of the Single European Market in 1993 led to fraudsters evading excise duty worth £668 million from diversion onto UK markets between 1993-94 and 1999-00, and another £216 million was accounted for as revenue lost from diversion onto overseas markets.
- 23 Following the introduction of the Single Market, Customs addressed the deficiencies in the system through a combination of fraud investigations and a tightening of controls. There were, though, weaknesses in their control of investigations and in their general counter fraud strategy.
- 24 As part of their ongoing dialogue with Customs, the Committee of Public Accounts and the National Audit Office raised concerns about excise duty fraud each year from 1994, culminating in the disclosure of losses in the National Audit Office report on Customs 1999-00 Accounts.
- 25 There are a number of areas where Customs could have responded to the frauds more effectively:
- When the frauds began in 1994, Customs did not have a high level strategy for how they should combat alcohol diversion fraud. Such a strategy was not completed until 2000. Dealing with the frauds at the time was seen as an operational matter largely within the National Investigation Service. The Service should have worked with other groups within the Department, such as policy teams, to address issues such as: the resources to be committed to anti-fraud work; authorisation for investigations and indemnities; deciding who to assess for lost revenue; and the division of responsibilities between the Service, Collections and Headquarters teams. The lack of a high level approach meant Customs took longer to draw up a co-ordinated response to the frauds.
 - Customs did not assess whether their policy of identifying suspect consignments and allowing fraudsters to move goods from excise warehouses under observation ("letting loads run") was a more effective way of tackling the frauds than disruption. "Letting loads run" unavoidably leads to the build up of arrears of duty, but with the intended objective of protecting the revenue by convicting fraudsters and recovering losses. The main alternative is to disrupt fraudulent activity as it is discovered, which protects potential revenue loss but is less likely to lead to conviction of the perpetrators. However, even with the benefit of hindsight, it is difficult to determine whether a policy of greater disruption would have led to a lower level of revenue losses.
 - Customs had inadequate management information on the levels of fraud as they first arose in 1994 and on the outcome of investigations. This meant that the first signs of significant losses from fraud were not fully appreciated. Customs did not know the full extent of the losses from the frauds investigated until a special exercise to identify them was carried out in 2000. Losses from any frauds which have not been investigated or identified are unknown.
 - For a number of investigations, Customs did not issue assessments against the fraudsters for the duty lost. As a consequence, Customs did not note the extent and circumstances of the identified losses in their accounts until 2001, a considerable time after the losses occurred.

- 26 The actions now planned by Customs should result in:
- tighter controls against fraud;
 - improved management of investigations of fraudsters; and
 - a better strategic approach to countering fraud.
- 27 Underpinning these improvements, we consider four initiatives are crucial. These are:
- developing an approved anti-fraud strategy, with explicit recognition that there is going to be a level of revenue loss if trade is to be facilitated (because this requires looser controls), an estimate of the unavoidable level of loss and an estimate of the risks (and the relative attractiveness and potential gain to fraudsters of different types of fraud);
 - developing and publishing reliable estimates of revenue "leakage", to give earlier warning that fraud risks may be maturing. Customs already publish such estimates for tobacco and some alcohol smuggling figures. Extending such estimates to cover all indirect taxes would provide a starting point for measuring the effectiveness of Customs and help indicate where resources should be targeted;
 - developing systems to give management information on anti-fraud activities, including the progress of investigations, and to provide anti-fraud intelligence;
 - ensuring the unification of anti-fraud resources under a single command works effectively, both internally and with other parts of the Department.

Annex A

Excise diversion frauds - chronology of events

January 1993	Creation of the Single European Market.
April 1994	Committee of Public Accounts report notes that Customs say that they have not detected any sign of increased fraud as a result of the Single Market. The Committee urges Customs to remain vigilant in the face of the acknowledged risks.
August 1995	First investigation of UK diversion fraud. Customs subsequently carry out more investigations of suspected frauds, using the method of "letting loads run" - identifying suspect consignments and allowing the fraudsters to move the goods whilst under observation, with the aim of protecting the revenue by identifying the principals behind the fraud and collecting sufficient evidence to secure their conviction.
April 1996	Customs' Internal Audit report highlights the rising level of fraud and the barriers to the effective operation of the duty suspension system.
July 1996	National Audit Office report to Customs on controlling excise and inland Customs traders highlights risks to the revenue from Customs' approach to handling traders and excise warehouses.
August 1996	Committee of Public Accounts report notes Customs' view that commercial fraud is a greater concern in terms of lost revenue than smuggling and the absence of usable estimates of revenue losses. The Committee looks to Customs to seek improved intelligence and to adopt appropriate counter measures.
1996-97	IMPEX (Import/Export) teams introduced to disrupt fraudulent activities.
1997	High Level Group on Alcohol and Tobacco Fraud set up in Europe to consider all aspects of alcohol and tobacco fraud.
April 1997	130 extra staff years allocated for IMPEX teams.
October 1997	Commissioner's direction allowed any officer to impose immediate conditions or restrictions on the removal of goods from a third party warehouse, thereby preventing/delaying the despatch of suspect movements.
1998	The Excise Duty Point (External and Internal Community Transit Procedures) Regulations 1998 provided a duty point where excise goods were moving under Community Transit Procedures and there was an irregularity or offence in the UK.
July 1998	Customs' Alcohol and Tobacco Fraud Review published.
October 1999	Warehousekeepers and Owners of Warehoused Goods Regulations 1999 provided for registration of both warehousekeepers and owners, allowing easy identification of those with an interest in goods involved in suspect movements.
May 2000	Departmental review of the events relating to Customs' investigation of excise diversion frauds between 1995 and 1998.
1 June 2000	Customs inform Paymaster General of the weaknesses in the control of excise duty collection.
30 June 2000	Paymaster General announces a full independent investigation into the collection of excise duties by John Roques, ex senior partner from Deloitte and Touche.
8 February 2001	Paymaster General informs Treasury Sub-Committee that Roques's work is not yet complete and that she will report fully on excise diversion when outstanding areas of work have been finalised.
9 February 2001	National Audit Office report on Customs Appropriation Accounts 1999/2000 records the extent of excise diversion losses.
Note:	Committee of Public Accounts Reports mentioned above examined reports by the National Audit Office on Customs Appropriation Accounts for the relevant year.