

**EXPLANATORY MEMORANDUM TO**  
**THE TOBACCO PRODUCTS (AMENDMENT) REGULATIONS**  
**2006**

**2006 No. 2368**

**1.** 1.1 This explanatory memorandum has been prepared by the Commissioners for Her Majesty's Revenue and Customs and is laid before Parliament by Command of Her Majesty.

1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

**2. Description**

This instrument amends the Tobacco Products Regulations 2001 (S.I. 2001/1712). It provides for the notification by the Commissioners of certain seizures of cigarettes or hand-rolling tobacco to those believed to have manufactured those products. It also makes provision for access to the products for the purposes of determining who manufactured them and for the provision of information in relation to them.

**3. Matters of special interest to the Joint Committee on Statutory Instruments**

This is the first exercise of the power to make regulations provided by section 7A(7) and 9(2) of the Tobacco Products Duty Act 1979(c.7) (as inserted by section 2 of the Finance Act 2006 (c. 25)).

**4. Legislative Background**

4.1 This instrument forms part of a package of measures being introduced by the Government to combat tobacco smuggling by making it harder for smugglers to source cigarettes and hand-rolling tobacco ("HRT"). It comes into force on 1 October 2006.

4.2 Section 2 of the Finance Act 2006 inserted new sections 7A to 7D and 9(2) into the Tobacco Products Duty Act 1979 ("TPDA 1979"). Under these new provisions tobacco manufacturers will be required to conduct their businesses in such a way as to avoid, so far as is reasonably practicable, supplying cigarettes or HRT to those likely to smuggle, or to those likely to resupply to those likely to smuggle, that product into the United Kingdom. Any failure to comply with this obligation may render a tobacco manufacturer liable to a penalty.

4.3 The new provisions will be brought into effect by the Finance Act 2006 (Tobacco Products Duty: Evasion)(Appointed Day) Order 2006 (S.I. 2006/2367 (C.80)) on 1 October 2006. That Order is not subject to any Parliamentary procedure.

4.4 Section 7A(7) and 9(2) of the TPDA 1979 contain powers to make regulations. This instrument is the first exercise of those powers.

4.5 The instrument requires the Commissioners to notify a manufacturer (as defined by section 7D(3) and (4) TPDA 1979) of a seizure of cigarettes or hand-rolling tobacco under section 139 of the Customs and Excise Management Act 1979 (c. 2). That section provides that any thing liable to forfeiture under the customs and excise Acts may be seized or detained by any officer of Her Majesty's Revenue and Customs, or constable, or any member of Her Majesty's armed forces or coastguard. Cigarettes or HRT imported into the UK without payment of the necessary duty are liable to forfeiture by virtue of section 7 of the TPDA 1979<sup>1</sup> and regulations 12 to 14 of the Tobacco Products Duty Regulations 2001.

4.6 The instrument makes provision for access to seized products for the purposes of determining who manufactured them. It also provides that a manufacturer who has been notified that a seizure has been made must provide the Commissioners with certain information about the seized products.

4.7 The manufacturer may be able to provide useful information about the seized products even if he did not manufacture them, or arrange for their manufacture, himself. One source of cigarettes or HRT available to smugglers is so called "unauthorised product". This is product that is manufactured on premises controlled by the manufacturer (or those acting on his behalf) but which is not authorised by him. For example, there may be situations in which product is manufactured "after hours" by a criminal gang or dishonest employees who use a particular factory after it has closed for the day. Although a manufacturer will not have authorised the production of that product he may, for example from the packet markings or codes used, be able to identify where the product was produced.

## **5. Extent**

This instrument applies to all of the United Kingdom.

## **6. European Convention on Human Rights**

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

## **7. Policy background**

7.1 In 2000, the Government launched the 'Tackling Tobacco Smuggling Strategy', setting out its innovative strategic approach to the threats from tobacco smuggling. Whilst this strategy has been successful in first halting the previously rapid growth of cigarette smuggling, and then reducing its level, tobacco smuggling remains unacceptably high, and smuggling patterns have changed since the strategy was introduced.

7.2 At Budget 2006 the Government announced a comprehensive range of new measures to reinforce the tobacco strategy. A full Regulatory Impact Assessment was published alongside that announcement. These Regulations form part of that package of measures, and are aimed at stemming the flow of lost revenue by making it harder for smugglers to source cigarettes and HRT.

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<sup>1</sup> As amended by section 9 of, and Schedule 4 to, the Finance Act 1994 (c. 9).

7.3 The UK tobacco manufacturers accept that they have a certain responsibility for ensuring that cigarettes and HRT, sold to markets outside the UK, are not supplied or re-supplied to persons likely to smuggle them into the UK. To this end a number of the UK tobacco manufacturers have agreed Memoranda of Understanding (MoUs) with the Commissioners.

7.4 The new legislation is designed to complement the MoUs and ensure that those manufacturers who support the Commissioners in their efforts to combat tobacco smuggling are not unfairly disadvantaged. It creates a level playing field by ensuring that the Commissioners have a means of encouraging improved product control from all tobacco manufacturers whose product might be targeted at the UK illicit market, not just those who consent to a voluntary agreement through the MoU. By exercising greater control of their supply chains, tobacco manufacturers can make it harder for smugglers to source tobacco products for the purpose of smuggling into the UK. These measures are also intended to facilitate dialogue and information sharing between the Commissioners and tobacco manufacturers, providing for a better understanding and early identification of smuggling risks.

7.5 However, if tobacco manufacturers fail to comply fully with the obligations imposed, penalties of up to £5 million may be issued to encourage an improvement in their compliance.

7.6 Throughout the development of the policy and the legislation, the Commissioners have consulted with the Tobacco Manufacturers Association (TMA), its members, and other tobacco manufacturers who either produce tobacco product in the UK, or whose products are present in the UK market. During this consultation process, these stakeholders were presented at an early stage with opportunities to contribute to the design of the supply chain control regime. A consultation document was issued in early 2006 and drafts of both the primary and secondary legislation have been made available for scrutiny and comment.

7.7 The tobacco manufacturers and the TMA requested some changes to the draft primary and secondary legislation, and these have been accommodated where possible. Where it has not been possible to agree changes the Commissioners have made stakeholders aware of the reasons for this. The TMA and its members have voiced support for the policy objectives.

## **8. Impact**

8.1 A full Regulatory Impact Assessment was published at Budget 2006 and is attached to this memorandum.

8.2 The impact on the public sector is nil.

## **9. Contact**

Judith Kelly at Her Majesty's Commissioners for Revenue and Customs, Tel: 0161 827 0313 or e-mail: [Judith.Kelly@hmrc.gsi.gov.uk](mailto:Judith.Kelly@hmrc.gsi.gov.uk), can answer any queries regarding the instrument.

# REGULATORY IMPACT ASSESSMENT (RIA)

## 1. Title of proposal

Tobacco Duty: Control of Supply Chains

## 2. Purpose and intended effect

- The policy objective

The Government announced in the Pre-Budget Report a package of measures to refresh the Tackling Tobacco Strategy. The introduction of this legislation is one of those measures aimed at reducing the availability of genuine tobacco products to smugglers.

The combination of measures will contribute towards HMRC's PSA target of reducing the illicit market share of cigarettes to no more than 13%, and reducing the illicit hand-rolling tobacco (HRT) market by 1,200 tonnes (around 20%) by 2007/08. The measures will contribute to the reduction of the tax gap and ensure that the relevant duties and taxes due on those products reach the Exchequer.

The legislation is designed to complement the Memorandum of Understanding (MoU) that HMRC have entered into with a number of leading UK tobacco manufacturers, and ensure that those manufacturers who support HMRC in their efforts to combat tobacco smuggling by doing so are not unfairly disadvantaged. Obligations will therefore be imposed on all tobacco manufacturers to control their supplies to non-UK markets, and ensure, as far as reasonably practicable that they do not facilitate smuggling.

Tobacco smuggling undermines the Government's policy of using taxation levels as part of its strategy to reduce the incidence of smoking in the UK population. By imposing requirements on tobacco manufacturers to control their supply chains and therefore making it difficult for criminal gangs to obtain large volumes of genuine product, the introduction of this scheme will support the Government's health policy.

- Background

Tobacco smuggling is a major contributory factor to the tax gap. HMRC figures show that:

- £2.9 billion in revenue is currently being lost each year
- Figures for 2003-04 show that 16% of cigarettes and 55% of HRT consumed in the UK were smuggled

Existing legislation in this area is a combination of EC Directives and domestic law. Within this legislation there are currently no requirements on tobacco manufacturers to consider the risks of potentially facilitating smuggling when supplying product to customers in non-UK markets, or to the markets generally in which they trade. There is similarly no duty to control the volume or mix of brands

a tobacco manufacturer supplies to a particular customer or market, to ensure that they are appropriate to the genuine demand for those products.

This has led to a situation where the volume of tobacco products entering certain markets outside the UK is significantly greater than the estimated total consumption of tobacco products in those countries and the demand of legitimate cross border shoppers. HMRC believe that the excess product is purchased by criminal gangs for the express purpose of smuggling it into the UK.

- Rationale for government intervention

A number of leading UK tobacco manufacturers, supported by the Tobacco Manufacturers Association (TMA) have been active in working with HMRC to tackle the problem of tobacco smuggling. The ensuing dialogue has resulted in the manufacturers involved entering into MoUs with HMRC, which set out a framework of cooperation aimed at the shared objective of limiting the smuggling of both contraband and counterfeit product into the UK. These agreements are an important step towards dealing with the problem of tobacco smuggling, and are representative of the co-operation of the manufactures involved. However the MoUs are voluntary agreements and only apply to the signatory manufacturers. By introducing legislation to complement and support the MoUs, all tobacco manufacturers are placed under the same obligations and they risk a penalty being imposed by HMRC for the breach of those obligations

### **3. Consultation**

- Within government

Enquiries were made with the Home Office, Department for Trade and Industry, and the Department for Constitutional Affairs (DCA). The main stakeholder is the DCA, which will have to make provision for extra VAT and Duties Tribunals. They are currently content that the impact in this area will not be significant; neither of the other departments believed they would be significantly affected by the proposals.

Contact has also been made with The Scottish Executive, The Northern Ireland Office, and Customs and Excise in the Isle of Man as the legislation is intended to apply across the UK. Additionally because the scheme impacts on manufacturers outside the UK, approaches were made to the European Commission. An outline of the scheme was provided, and again HMRC have not received any expression of concern, or comments from those that were approached.

- Public consultation

The measure was originally announced in December 2005 as part of the Pre Budget Report. A discussion document was issued to the tobacco manufacturers during January 2006, following which meetings were held with a number of tobacco manufacturers and the Tobacco Manufacturers Association (TMA).

A joint response was received from the TMA on behalf of its members, and also from one other tobacco manufacturer. Following these representations the detail of

the scheme was revised to incorporate as far as possible the legitimate views and concerns of the respondents.

The legislation impacts only upon tobacco manufacturers; as such it was not considered appropriate to extend the consultation further.

#### **4. Options**

During 2005 discussions were held within HMRC regarding the volume of genuine tobacco products reaching organised criminal gangs in commercially viable quantities. This resulted in the identification of a number of possible options to address the issue. However, on further analysis, all but one of these options was discounted on various grounds including effectiveness, compatibility with other legislation, complexity, and cost.

##### **Option 1: Do nothing**

If we do not take action, organised criminal gangs will continue to exploit weaknesses in supply chains and be able to source genuine tobacco products in commercial quantities. Revenue will continue to be lost, public health initiatives undermined, and retailers of UK duty paid product disadvantaged. Profits from the illegal activity will continue to accrue, and may be used to fund other illegal activities with consequential implications, both financial and social.

- **Option 2: Introduce legislation complementary to the existing MoUs**

The legislation will impose duties on all tobacco manufacturers to assess and address the risks involved in selling their product. Firstly manufacturers will be required to maintain a written policy that specifies the actions they will take to ensure that their supply chains, and where practicable the supply chains of their customers are as secure as is reasonably possible. Secondly the legislation will require them to sell their products in quantities that are commensurate with the consumption of their product in the destination country and any additional demand from legitimate cross border shopping. Thirdly they will be required to furnish to HMRC information relating to the markets in which they operate, and any product seized by HMRC in order that HMRC can assess the effectiveness of their policies, controls and actions. The legislation is framed so as to mirror the main obligations of the MOUs, and in so doing extend those obligations to all manufacturers. Where manufacturers did not comply with these duties the legislation would allow for the raising of a financial penalty.

#### **5. Costs and benefits**

- **Sectors and groups affected**

The only businesses that will be directly affected by the introduction of the new legislation are tobacco manufacturers.

Retailers of UK duty paid tobacco products may indirectly benefit from a reduction in the amount of genuine tobacco product on the UK illicit market, resulting from the requirements being imposed on tobacco manufacturers to

control their supply chains, and the increased difficulty smugglers will face sourcing genuine cigarettes and HRT.

The proposal will have no race, Human Rights, Northern Ireland or other equality impacts.

- Benefits

Option 1: Do nothing.

The MoUs currently in place with leading UK tobacco manufacturers should contribute to reducing the availability of genuine product to smugglers. However, the MoUs are voluntary agreements and are limited to those signatories who have agreed to cooperate with HMRC. There is also no recourse if a tobacco manufacturer chooses to opt out of, or selectively adheres to the terms of the MoU.

By doing nothing, and failing to require other manufacturers to control their supply, HMRC risks undermining the agreements and the commitment they represent. Organised criminal gangs will continue to exploit weaknesses in supply chains where manufacturers do not have MoUs or similarly extensive control policies. There is therefore no benefit to inaction.

Option 2: Introduce legislation complementary to the existing MoUs

By introducing legislation HMRC can extend the potential benefits to be gained from the MoUs to all manufacturers. This would prevent the MoUs being undermined, and place comparable responsibilities on all tobacco manufacturers, not just those who have voluntarily undertaken to work with HMRC. Creating a legal duty on all tobacco manufacturers to have effective controls over their supply chains avoids displacing the issue to other manufacturers.

The scheme is designed to encourage the exchange of information between HMRC and tobacco manufacturers, providing for a greater understanding of the size of the market and the nature of the smuggling risks, whilst also notifying tobacco manufacturers of potential weakness in their supply chains through details of material seizures.

If a tobacco manufacturer does not comply with the obligations imposed, the scheme enables HMRC to issue substantial penalties to encourage compliance with the scheme, and ensure other tobacco manufacturers who do comply are not disadvantaged.

By reducing the availability of genuine tobacco products to smugglers the scheme, along with other measures announced as part of the strategy, will help to disrupt the activities of organised criminal gangs and thus impact on the profits available to fund other illegal activity, with consequential financial and social benefits.

By disrupting supplies of genuine product to organised criminal gangs, the scheme will help to reduce the availability of smuggled genuine product available in the UK. This will have consequential benefits for retailers of UK duty paid tobacco products, whose businesses are detrimentally affected by the illicit trade.

- **Costs**

To tobacco manufacturers

The legislation is deliberately designed to mirror the MoU working arrangements already agreed with leading UK tobacco manufacturers; as such any additional costs to those manufacturers should be minimal. For example, the examination, testing and tracing of product from significant seizures have cost implications, but these activities have, for some time been carried out by a number of tobacco manufacturers on a voluntary basis.

In meetings with HMRC the tobacco manufacturers indicated that there might be some additional costs arising from the legislation. For example, some expressed their intention to physically inspect all material seizures, as they would be entitled under the legislation. This would have some consequential costs, which the tobacco manufacturers have not yet quantified in their written responses to the discussion document.

In other circumstances, where tobacco manufacturers follow good business practice in terms of whom they deal with and how they regulate such relationships, the legislation will impose minimal additional costs – e.g. tobacco manufacturers will incur the costs associated with setting up and maintaining a supply policy, if they do not already have one. Further costs will only be incurred if significant quantities of genuine products are seized from smugglers who have been able to source large quantities of a tobacco manufacturer's product. Overall, HMRC believe that any costs incurred are likely to be proportionate to the objectives and benefits of the scheme.

To HMRC

Administration of the scheme will be managed from within existing resources and procedurally through the adaptation of existing systems.

There will be some additional storage requirements at the Queens Warehouse in relation to holding seizures under the scheme, which will carry some cost, as will facilitating the inspection of seizures by manufacturers. However, there is sufficient extra capacity currently available and this will be monitored along with the impact of the full package of measures.

## **6. Small Firms Impact Test**

The scheme applies to all tobacco manufacturers regardless of size, in that they must have a supply policy, and this policy would be a factor in any penalty issued under the scheme. However, in the main, tobacco manufacturers are multi-national corporations, and the size of the seizure threshold makes it very unlikely that HMRC would make a material seizure, or repeated material seizures of product from the limited number of smaller manufacturers.

## **7. Competition assessment**



The legislation addresses the illicit trade in cigarettes and hand-rolling tobacco, and places no restriction on bona fide transactions. As such tobacco manufacturers will not be at a competitive disadvantage in any genuine market in which they operate.

It is the opinion of HMRC that none of the options considered bring about any competition issues for tobacco manufacturers.

## **8. Enforcement, sanctions and monitoring**

The legislation will impose specific obligations on tobacco manufacturers, namely to take reasonably practicable steps to prevent their tobacco products leaving the legitimate supply chains, and becoming available to organised criminal gangs in commercial quantities for the purpose of smuggling.

HMRC will assure compliance with the terms of the scheme and the MOUs through their risk and assurance programmes, monitoring levels of seizures and notifying the trade of any material seizures as required. The scheme provides for an open and continual dialogue with the tobacco manufacturers regarding their actions, and the measures undertaken to address issues of supply chain control, which will facilitate the monitoring and enforcement of the scheme.

The scheme permits a sanction of up to £5,000,000 for those manufacturers who fail to comply with the responsibilities placed upon them.

## **9. Implementation and delivery plan**

The measure will be introduced by Finance Bill 2006 and will be implemented in Autumn 2006. Existing teams within HMRC who already have well-established links with tobacco manufacturers will deliver the scheme.

## **10. Post-implementation review**

The operation of the scheme and its impact upon tobacco smuggling will be monitored by HMRC as part of an ongoing process of review and assessment.

## **11. Summary and recommendation**

The measure affects a small number of predominantly large businesses both in the UK and abroad, and for those already following good business practice in the areas concerned, it should have very little discernible impact.

Whilst some tobacco manufacturers and the TMA have mentioned in meetings with HMRC that there may be some additional costs relating to the scheme, these have not yet been quantified. However, any costs incurred are likely to be proportionate to the objectives and benefits of the scheme.

The scheme is fit for the purpose for which it was designed with minimal regulatory impact and it is recommended for acceptance.

# REGULATORY IMPACT ASSESSMENT

## Tobacco Duty Control Of Supply Chains

### Statement of Ministerial Approval

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

*John Healey MP*

Financial Secretary to the Treasury

16th March 2006