



Australian Government
Australian Taxation Office

ATO Submission

Inquiry into Illicit Tobacco

29 November 2019

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Introduction

1. On 6 November 2019, the Parliamentary Joint Committee on Law Enforcement invited the Australian Taxation Office (ATO) to provide an updated submission to the inquiry into Illicit Tobacco and report on the following matters:
 - an update on tax gap estimates and the risk assessment of illicit tobacco
 - the latest illicit tobacco data and methodologies engaged in deriving the tax gap estimate
 - notable outcomes from the 2018 reform of Tobacco Excise and Customs Legislation.
2. The ATO has previously provided two submissions and attended two public hearings in respect to this inquiry:
 - the first ATO submission was made in February 2016
 - the ATO attended the first public hearing on 4 March 2016
 - the second ATO submission was made in November 2016
 - the ATO attended the second public hearing on 23 November 2016.
3. Topics discussed at the public hearings, and via questions on notice, were the ATO waste water study, the tax gap, the track and trace regime, the illicit tobacco risk assessment and the March 2015 *ANAO Audit Report – Gaps and Vulnerabilities*.
4. Links to the previous ATO submissions and questions on notice are provided at Appendix A.
5. The ATO welcomes the opportunity to provide the Committee with an updated submission containing the latest data and addressing our key focus areas relating to illicit tobacco.

The regulatory framework

6. The regulatory framework for tobacco is administered by the ATO and the Department of Home Affairs (Home Affairs). The ATO is responsible for detecting and seizing tobacco illegally grown in Australia. Home Affairs is responsible for levying customs duty on imported tobacco.
7. On 16 August 2018, the Government passed the *Treasury Laws Amendment (Illicit Tobacco Offences) Bill 2018*. Complementary legislation to strengthen illicit tobacco offences under the *Customs Act 1901 (the Customs Amendment (Illicit Tobacco Offences) Bill 2018)* was passed on 23 August 2018.
8. The new tobacco offence regime sets penalties at a level to deter illegal activity with up to 10 years imprisonment and significant monetary penalties for manufacturing, producing, selling, buying or possessing illicit tobacco. Investigators also no longer need to prove the origin of the tobacco before applying the offences. The new laws enable the ATO to seize and destroy illicit tobacco, even if it cannot be proved that it was grown domestically.
9. The Budget announcement to collect tobacco duties and taxes at the border commenced on 1 July 2019. The *Customs Amendment (Collecting Tobacco Duties at the Border) Bill 2018* received royal assent on 25 October 2018. The *Treasury Laws Amendment (Black Economy Taskforce Measures No. 2) Bill 2018* and the *Excise Tariff Amendment (Collecting Tobacco Duties at Manufacture) Bill 2018* received royal assent on 29 November 2018. These bills amended the *Excise Act 1901* and *Taxation Administration Act 1953*, with Importers now required to pay all duty and tax liabilities upon the arrival of tobacco into Australia to Home Affairs.
10. The Final Budget Outcome official figures¹ capture the size of the legal Australian tobacco market, with revenue obtained from customs and excise duties outlined below.

2013–14	\$8,498 million
2014–15	\$8,848 million
2015–16	\$9,816 million
2016–17	\$10,453 million
2017–18	\$11,879 million
2018–19	\$12,130 million

Illicit tobacco

11. On 1 July 2018, the Illicit Tobacco Taskforce (ITTF) was established as part of the Government's Black Economy Package revenue measures, which were announced in the 2018–19 Budget. The multi-agency taskforce was created to enhance the whole-of-government response to disrupt and prosecute serious actors and members of organised crime groups operating in the illicit tobacco market.
12. The ITTF is led by the Australian Border Force (ABF) with membership from a number of Commonwealth agencies including the ATO.

¹ www.budget.gov.au

13. In addition to our role in the ITTF, the ATO is responsible for detecting, seizing and investigating illicit domestically grown or manufactured tobacco products. As no commercial production licences have been issued since 2006, it has been illegal to grow tobacco in Australia since that time.
14. Based on the low levels of domestic illicit tobacco seizures since 2007 the ATO considers the overall domestic production of illicit tobacco products to be a small revenue risk. Further, based on reported cross-border seizures of illicit tobacco, the ATO considers that illegal importations are the major source for illicit tobacco products entering domestic retail markets. Up until the taxing point shifted to the border on 1 July 2019, warehouse leakage was the third source of illicit tobacco entering the retail market. A breakdown of ATO and DIBP/ABF seizures is provided below.

Table 1: Tobacco Seizures from 2007–08 to 2018–19

Year	ATO Seizures ^{2 3} Tonnes	DIBP/ABF Seizures ⁴ Tonnes
2007–08	9.9	287
2008–09	0	180
2009–10	5.7	311
2010–11	31	258
2011–12	26	177
2012–13	0	183
2013–14	35	183
2014–15	16	182
2015–16	132	147
2016–17	147	358
2017–18	98	432
2018–19	41	633
Total	541.6	3,331

² Gross weight – may include wet and dry tobacco products

³ <https://www.ato.gov.au/General/The-fight-against-tax-crime/Our-focus/Illicit-Tobacco/>

⁴ <https://www.homeaffairs.gov.au/reports-and-publications/reports/annual-reports>

Response to the terms of reference

The nature, prevalence and culture of illicit tobacco use in Australia, including in Indigenous, regional and non-English speaking communities

15. The ATO’s intelligence focus is on the growing and movement of domestically grown illicit tobacco. The ATO identifies illicit crops by using formal networks, community tip-off information and disseminations of intelligence from our ITTF partners and state law enforcement agencies.
16. Low numbers of seizures of domestically grown or manufactured tobacco and intelligence indicates that domestic illicit tobacco currently presents a small revenue risk. However this risk may grow over time to meet black market demand if border controls become more effective. The number of illicit tobacco seizures made by the ATO and estimated excise avoided is outlined below.

Table 2: Tobacco seizures made by the ATO from 2016–17 to 2018–19

Financial Year	Number of Seizures	Amount Seized and destroyed	Estimated Excise avoided
2016–17	15	117,000 kg	\$90m
2017–18	19	98,000 kg	\$90m
2018–19	8	41,000 kg	\$42m
Total	42	256,000 kg	\$222m

17. The ATO does not have any information available on the cultural use of illicit tobacco in Australia.

The role of Commonwealth law enforcement agencies in responding to the importation, use, manufacture, distribution and domestic growth of illicit tobacco

The ATO’s role

18. The illicit tobacco market is primarily supplied by organised crime syndicates who sell tobacco products for home consumption at a discounted price and without duty collected.

19. As members of the ITTF, the ATO's role is to:

- help support the removal of the wealth from organised crime syndicates, including through tax audit and civil debt recovery, where appropriate
- execute ATO warrant powers on ITTF endorsed operations in respect to organised crime syndicates identified domestic crops, plant and machinery
- play a key role in the collection, analysis and dissemination of illicit tobacco intelligence to/from our ITTF partners, the community and state policing authorities.

20. The ATO also has responsibility for detecting, seizing and investigating illicit tobacco grown in Australia.

The risk environment

21. **Tax gap**⁵ – The ATO and Home Affairs partnered with tax gap experts to produce a measure of the tobacco tax gap for 2017–18. The reported tax gap is estimated to be \$647 million or 5.0% of the amount of collectable tobacco excise. Further details of the 2017–18 tax gap is provided below.

22. **KPMG's Illicit Tobacco in Australia**⁶ – The 2018 KPMG full year report on illicit tobacco in Australia (dated 3 May 2019) was prepared for Philip Morris Limited and Imperial Tobacco Australia Limited. The report found that legal tobacco consumption and illicit tobacco consumption decreased from the previous year. The report estimates that the illicit market is approximately 14.1% of the total tobacco market in Australia (down from 15% in 2017), with a notional excise value of \$2.02 billion.

ATO illicit tobacco strategy

23. The ATO's primary focus is to remove illicit tobacco at the source of the supply chain. By seizing and destroying illicit tobacco during domestic cultivation it removes the opportunity to reach end consumers through retail suppliers.

24. The ATO engages the five strategies – target development, education, assurance, enforcement and whole-of-government – in identifying and disrupting domestic illicit tobacco and supporting ITTF initiatives.

Target development: Analyse operational intelligence to identify high risk syndicates and illicit tobacco growing hotspots

25. Our operational intelligence unit sends/receives and analyses information and intelligence sourced from the community, state police and agencies, ITTF partner agencies and other Commonwealth departments. Our illicit tobacco intelligence program focuses on identifying target opportunities and organised crime syndicates' operating models.

26. Since 1 July 2018, the ATO has received 350 referrals and made 154 disclosures to ITTF partners pertaining to retailers, domestic crops, importation and manufacturing. The ATO contributed intelligence holdings to 13 ITTF operations and seven target development projects. In addition, we referred 31 matters of interest to the ITTF and provided regular updates on ATO activities such as audits and communication campaigns.

⁵ <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Tobacco-tax-gap/>

⁶ https://www.pmi.com/resources/docs/default-source/australia-market/kpmg-illicit-tobacco-in-australia-2018.pdf?sfvrsn=90c092b5_2

Education: Implement communication strategies raising community awareness

27. In 2018–19, the ATO implemented a tailored communication strategy aimed at providing awareness to the Australian community of illicit tobacco and how to report suspicious activity. The communication strategy included:
- March 2019 – paid advertising campaigns in newspapers, Facebook advertisements and Google search and display, estimated to have reached an audience of over 540,000
 - seven media releases reaching an estimated audience of 7 million across online, print, radio and television.
28. In February 2019, we issued 3000 letters to land owners that were identified as owning land in known New South Wales and Victorian tobacco growing regions. The awareness campaign was aimed at informing landowners that organised syndicates had been targeting unsuspecting landowners by attempting to lease or sub-lease land to illegally grow tobacco.
29. On 1 November 2019, the ATO issued 16,000 letters to tobacco retailers throughout NSW. The awareness campaign was aimed at educating businesses that sell tobacco products that organised crime syndicates have been targeting small tobacco retailers across Australia to buy and sell illegally grown or imported tobacco products. It also outlined the penalties that may apply for selling illicit tobacco products.
30. The ATO continues to engage and present educational material to law enforcement agencies in rural locations (Northern Territory in December 2018 and NSW in August 2019) to generate better informed intelligence and strengthen relationships with police in known illicit tobacco growing locations.

Assurance: Target unexplained wealth through civil audit and lodgement compliance

31. The ATO civil audit team is targeting unexplained wealth on high risk ITTF cases.
32. There are currently 12 audits underway, across three endorsed ITTF operations, with a further 10 audits pending approval. The ITTF ATO audit team works closely with ATO's Strategic Debt area to provide a streamlined service to its ITTF partners. The combined estimated undisclosed income for the 12 audits underway is \$10.3m with unpaid tax, penalties and interest of approximately \$5.5m.

Enforcement: Target high risk syndicates in illicit tobacco through ATO investigations and prosecution activities and joint operations with ITTF

33. Since 1 July 2018, the ATO has supported the ITTF in targeting high risk illicit tobacco syndicates through the seizure and destruction of domestically grown illicit tobacco crops, cigarette sticks and equipment. Those seizures include:
- On 25 July 2018, an operation took place at three Northern Territory properties with 17 acres of illicit tobacco crop and 6,000 kilograms of tobacco leaf from a drying kiln seized and destroyed, with an estimated excise duty forgone of \$13.24 million.
 - On 11 August 2018, a property was attended in Grafton, NSW, where nearly three acres of illegally grown tobacco was located. Approximately 1.5 tonnes of illicit tobacco was destroyed with an estimated excise duty forgone of \$1.4 million.
 - On 11 January 2019, an operation took place at Araluen, NSW, with eight acres containing approximate 45,000 plants which were seized and destroyed, with an estimated excise duty forgone of \$9.15 million.

- On 16 and 17 April 2019, properties in Wunghnu, Victoria, and Lalaly, NSW, were attended. Approximately 40 acres of illicit tobacco crop was seized and destroyed with an estimated excise duty forgone of \$18.5 million.
 - On 11 July 2019, the ATO and ABF attended a warehouse in Lidcombe, NSW, where various brands of illicit cigarettes, loose leaf and cigarette manufacturing machines were seized.
34. Complementing ITTF operations, the ATO continues to seize and destroy illicit domestic tobacco identified by state and territory law enforcement agencies. ATO activity since 1 July 2018 includes:
- On 20 February 2019, ATO investigators attended a property in Oxley, Victoria, together with Victoria Police where the person of interest relinquished 150 illicit tobacco plants. The estimated excise value forgone was \$16,145.
 - On 20 July 2019, Queensland Police and the Queensland Department of Health executed a search warrant on a retailer in Logan, Queensland. The police transferred the evidence and investigation to the ATO, in respect to 374 packets of illicit cigarettes and two kilograms of illicit loose tobacco. A penalty infringement notice for \$4,200 was issued by the ATO under new provisions contained within *Tax Administration Act (1953)*.
35. Since 1 July 2018, four people have been convicted and sentenced to jail terms of up to three years. Fifteen matters are currently under investigation or with the Commonwealth Director of Public Prosecutions.

Whole-of-government: Develop work programs with ITTF and internal stakeholders, including strategies for ceasing of licenced warehouses

36. The ATO assists ITTF partner agencies in developing work programs through intelligence collections from the community, domestic crop destructions and state policing as well as through our audit activities to remove wealth.
37. Under the *Collecting tobacco duties and taxes at the border* measure announced in the 2018 Budget, from 1 July 2019 importers are required to pay all duty and tax liabilities upon the arrival of tobacco into Australia and the option to store underbond tobacco in licensed warehouses has been removed. Duty on imported tobacco is payable to Home Affairs.
38. The ATO compliance strategy for ceasing of warehouse licences included assisting clients to understand and manage the transition and to provide revenue assurance around the amount of tobacco still in warehouses on 1 July 2019 and liable for duty.
39. The ATO conducted educational visits to 21 warehouses and 22 importers between July 2018 and April 2019. All remaining warehouse operators and importers were contacted by phone. The ATO conducted 52 field enquiries between July 2018 and May 2019 concerning stock levels. We also supervised the destruction of over 72 million sticks and 7,524 kilograms of tobacco from January 2019. The risk based compliance treatment strategy included data assurance and stock reconciliation activities coupled with a field compliance strategy to physically verify under bond stock levels in warehouses. Where appropriate, joint field compliance activity was undertaken with ABF staff.
40. From 1 July 2019, licences are no longer issued to store tobacco. Licences that were in place prior to the change in taxing point have been cancelled or amended to remove tobacco products.

The loss of revenue to the Commonwealth arising from the consumption of illicit tobacco products

Illicit tobacco tax gap

41. In May 2018, the first tobacco tax gap was released in respect to the 2015–16 financial year. We estimated the tax gap to be 5.6% or \$594 million.
42. In October 2019, the tobacco tax gap for 2016–17 and 2017–18 was released. Due to updated data we also revised the 2015–16 estimates down slightly to 5.5% or \$585 million.
43. For 2017–18 we estimate the tobacco tax gap to be \$647 million. This figure represents the excise or customs duty value of illicit tobacco that is estimated to have gone undetected by compliance activities (Gross gap less seizures of illicit tobacco).
44. The tobacco tax gap increase from 2015–16 (\$585 million) to 2017–18 (\$647 million) is largely as a result of a 12.5 percent annual increase in the excise rate, effective from 1 September 2017. Excise rates on tobacco and tobacco products also increase in March and September each year based on average weekly ordinary time earnings.

Table 3: Tobacco Tax Gap estimate, 201516 to 2017–18

	2015–16	2016–17	2017–18
Gross gap	\$720m	\$934m	\$1,094m
Seizures of illicit tobacco	\$135m	\$355m	\$447m
Net gap \$	\$585m	\$579m	\$647m
Tax paid	\$10,063m	\$10,967m	\$12,361m
Theoretical liability	\$10,648m	\$11,546m	\$13,008m
Gross gap %	6.8%	8.1%	8.4%
Net gap %	5.5%	5.0%	5.0%

45. When compared to the total value of tobacco excises and duties, the gap has trended downward from 5.5% to 5.0% from 2015–16 to 2017–18 driven by better detection and disruption of illicit tobacco both at the border and domestic cultivation.
46. Illicit tobacco enters the Australian market through the following supply channels:
 - tobacco domestically grown without a licence, commonly referred to as ‘chop-chop’
 - leakages of ‘under bond’ tobacco from licensed customs warehouses
 - tobacco arriving through international post without tobacco duty paid
 - tobacco brought in through international passenger arrivals in excess of the 25-stick limit, without tobacco duty paid
 - sea and air cargo – the most significant source of detected illicit tobacco currently entering Australia. This typically comprises a small number of high-value detections in sea cargo and smaller amounts through air cargo.

Tax gap data and methodology

47. Tax gap measurements provide the ATO and the community with insights into the overall health of our tax system. The tobacco tax gap is the difference between the estimated values of excise or customs duty (tax) raised from tobacco according to the law and the value actually raised for the financial year.
48. The gross gap amount is an estimate of the total illicit tobacco market (i.e. \$1,094 million in 2017–18) comprising of tobacco seized under compliance activities (i.e. \$447 million in 2017–18) and an estimate of the value of illicit tobacco that has gone undetected and potentially reached the market (i.e. \$647 million in 2017–18).
49. The reliability of this estimate is assessed as medium.
50. The tobacco gross gap percentage trended upwards from 2015–16 (6.8%) to 2017–18 (8.4%) based on an estimated increase in illicit tobacco supplied to market.
51. The value of illicit tobacco that is estimated to have gone undetected and potentially reached the market, known as the net gap amount, is comprised of:
 - duty lost through illegal imports (based on Home Affairs analysis)
 - the excise value of domestic tobacco production entering home consumption.
 - duty lost through tobacco warehouse leakages.
52. The value of seizures of illicit tobacco has increased 320 percent from \$135 million in 2015–16 to \$447 million in 2017–18 estimates. The increase in seizures is attributed to better intelligence from the community and law enforcement agencies, resulting from our education and awareness activities. The seizures include compliance activities undertaken by the ATO in domestic cultivation (chop-chop) and illicit importations by the ABF. The gap period is prior to the formation of the Illicit Tobacco Taskforce which commenced 1 July 2018.
53. The tax paid (\$12,361 million in 2017–18) comprises of:
 - duty and excise paid on legitimate sales
 - duty and excise on seized illicit tobacco
 - GST is excluded.
54. There are five broad steps to estimating the tobacco tax gap – this is outlined in the chart below. Further detail is included at Appendix B.



55. We consulted with an independent expert panel for the most suitable methodology, and produced our tax gap estimate using a supply-side, bottom-up approach. This incorporates a number of separate analyses across the various supply channels where tobacco may enter consumption without tobacco duty applied. It is considered the most suitable approach given the body of cross-agency seizure data available.

56. The independent expert panel consisted of Saul Eslake, independent economist and vice-chancellor's fellow at the University of Tasmania, Richard Highfield, former advisor to the Organisation for Economic Co-operation and Development (OECD), and Professor Neil Warren, University of New South Wales. The panel provided consultancy services to assist develop and refine our approach to the tobacco tax gap.
57. The statistical analysis covering the illicit tobacco importation channels has also been independently reviewed by Professor James Brown, a statistician from the University of Technology Sydney.

Waste water analysis

58. We investigated measuring the community's tobacco consumption through wastewater analysis for tax gap estimate. Reading nicotine metabolites contained in sewerage can objectively indicate trends in tobacco consumption.
59. The resulting wastewater analysis showed that due to the chemical structure of nicotine, the metabolites broke down through the wastewater process. This resulted in nicotine metabolite levels being lower than the known supply of legal tobacco.
60. Consequently, waste water analysis was abandoned as a method or input into the tobacco tax gap estimates. However, we continue to monitor the wastewater studies being undertaken by various universities for potential future use.

The involvement of organised crime, including international organised crime, in the importation, distribution and use of illicit tobacco in Australia

Involvement of organised crime

61. The illicit tobacco market is primarily supplied by organised criminal syndicates.
62. Tobacco duty forms a significant component of the final price of tobacco products, and products that enter into home consumption without duty collected can be sold at amounts significantly less than legal tobacco.
63. This price differential creates an opportunity for suppliers of illicit tobacco to supply discounted products that find a ready market while providing a profit.
64. The profits which these syndicates make from the sale of illicit tobacco fund their lifestyles and allow them to continue to engage in criminal behaviour well beyond the sale of illicit tobacco. It also takes away potential tax dollars from the Australian community.

The effectiveness of relevant Commonwealth legislation

65. The ATO recently issued a penalty infringement notice (PIN) under new provisions to a retailer in possession of illicit tobacco. Excise Act PIN's can now be issued for tobacco possession offences under section 295-75 of the *Tax Administration Act (1953)* which provides for an offence where a person is unable to provide documentation (such as a tax invoice or customs invoice) to demonstrate how they came into possession of the tobacco. Tobacco in this instance refers to both loose leaf and manufactured tobacco products greater than 2 kilograms regardless of origin.
66. A PIN is set at a fixed amount of 20 penalty units (currently \$4200) and is payable within 28 days. If not paid, the PIN is withdrawn and a criminal investigation commences. Investigation action is also commenced for repeat offenders.

67. Other matters pertaining to the new offences remain under investigation or before the Commonwealth Director of Public Prosecutions.

Other related issues

Update on the ANAO Gaps and Vulnerabilities Report 2015

68. The ATO last updated the Gaps and Vulnerabilities Report in June 2016 where it was recommended that the Inter-Agency Liaison Committee note that the vulnerabilities identified in the 2013 review have been addressed to the point where the risks associated with them are now considered to be within tolerance and subject to ongoing maintenance.

Information sharing and protocols

69. Since the ITTF commenced on 1 July 2018, there has been an increase in information sharing between taskforce agencies, both at a strategic and operational level. Communications protocols have been established between the member agencies.

ATO's tobacco risk assessment

70. The excise equivalent goods (EEG) risk assessment, which included tobacco, was finalised by the ATO in February 2017. The overall risk rating for EEG was assessed as significant. This was largely due to the high value of the goods involved and previous history/evidence of non-compliant behaviour. Annual reviews of that risk assessment maintained the significant risk rating.
71. From 1 July 2019, the EEG tobacco risk, which represented a significant part of the EEG risk, is no longer the responsibility of the ATO following the shifting of the taxing point to the border.
72. From 1 July 2019, the risk assessment for EEG has been reduced from significant to moderate. This reflects the change in the taxing point of imported tobacco which is now solely administered by Home Affairs.

Handover points and integrated cargo system access

73. The ATO is receiving all additional data fields requested in relation to EEGs and there are no systemic issues with the ATO accessing Home Affairs' Integrated Cargo System. This provides greater visibility of the movement of goods (including exports), improved information sharing and facilitates greater collaboration between the two agencies.

Co-ordinated warehouse compliance activities

74. Information sharing on warehouse risks and vulnerabilities has occurred on an ongoing basis. This included a joint ATO and ABF tobacco risk assessment which provided a focus for compliance activities.
75. In consultation with Home Affairs, compliance activities undertaken by the ATO in relation to reforms to the taxing point for tobacco included warehouse stocktakes, reconciliation of stock movements and warehouse stock holdings figures.

Notable tobacco excise changes on 2018 legislative reform

Warehouses and licencing

76. As part of the 2018 Federal Budget, the Government announced it would target the three main sources of illicit tobacco in Australia (smuggling, leakage from licensed warehouses and domestic production) through a package of five related measures which are summarised below.

Combating Illicit Tobacco Package Measures	Description
Collecting tobacco duties and taxes at the border	From 1 July 2019, importers of tobacco will be required to pay all duty and tax liabilities upon importation.
Creation of the Illicit Tobacco Taskforce	From 1 July 2018, a multi-agency Illicit Tobacco Taskforce will be formed, comprising members from a number of law enforcement and border security agencies, to increase the resources and capabilities dedicated to combatting illicit tobacco smuggling.
Additional resources to combat domestic tobacco crops	From 1 July 2018, the ATO will be provided ongoing funding to bolster its capabilities to detect and destroy domestically grown illicit tobacco crops.
Introducing a prohibited import control for tobacco	From 1 July 2019, permits will be required for all tobacco imports (except for tobacco imported by travellers within duty free limits).
ATO excise systems upgrade	The ATO will upgrade and modernise its excise and excise equivalent goods payment systems beginning 2020–21 to replace the outdated paper lodgement system.

77. Under the Collecting tobacco duties and taxes at the border measure, from 1 July 2019 importers are required to pay all duty and tax liabilities upon the arrival of tobacco into Australia and the option to store underbond tobacco in licensed warehouses has been removed. Duty on imported tobacco is payable to Home Affairs.

78. Previously, tobacco could be stored in licenced warehouses for extended periods before entering the market for domestic consumption and being taxed. This provided an opportunity for warehoused tobacco to be stolen or diverted into the illicit market.

79. The ATO administered 48 licenced warehouses storing underbond tobacco under delegation from Home Affairs. Under this arrangement, the ATO undertook a compliance role in the lead up to the change of the taxing point, including assisting clients to understand and manage the transition and to provide revenue assurance around the amount of tobacco still in warehouses on 1 July 2019 and liable for duty.

80. Following the Budget announcement in May 2018, the ATO reviewed the previous warehouse risk assessments conducted jointly with the ABF and the updated assessments were reviewed and endorsed by the Department of Home Affairs. Where appropriate, joint compliance activity was undertaken with ABF staff.
81. From 1 July 2019, licences are no longer issued to store tobacco. Licences that were in place prior to the change in taxing point have been cancelled or amended to remove tobacco products.

Appendix A

Links to the previous ATO submissions and questions on notice

1. [ATO submission – Inquiry into illicit tobacco – February 2016](#)
2. [ATO submission – Inquiry into illicit tobacco – November 2016](#)
3. [ATO Waste Water study Question on Notice – March 2016](#)
4. [The ANAO’s audit report Question on Notice – November 2016](#)

Appendix B

Steps to estimating the tobacco tax gap

Step 1: Estimate illicit tobacco arriving through importation

1. This step involves estimating illicit tobacco arriving through importation. A statistical analysis was developed to estimate the quantity of illicit tobacco arriving through sea, air cargo and international post channels.
2. The total of these analyses suggests around 719 tonnes of illicit tobacco was imported into Australia in 2017–18, representing \$637 million worth of tobacco duty. A portion of this, valued at \$360 million, is seized through compliance activity before it reaches the domestic market.

Table 1: 2017–18 estimate of illicit tobacco arriving through importation

Gross \$m	Seized \$m	Net \$m
637	360	277

Step 2: Estimate the size of domestic chop-chop cultivation

3. In this step we estimate the size of domestic 'chop-chop' cultivation. An excise licence is required to cultivate tobacco, which places strict rules and conditions on growers. There are currently no licences issued for the cultivation of tobacco in Australia for either commercial or personal use. Therefore, all tobacco grown in Australia for consumption is illicit.
4. To estimate the value of this channel we analyse the value of seizures, risk, and intelligence referrals and created an uplift factor. This covers domestically cultivated tobacco that has not been detected or reported to authorities. This uplift was developed through referencing under-reporting of crime statistics from the Australian Institute of Criminology.
5. In 2017–18, we seized 98 tonnes of domestically grown tobacco worth \$87 million⁷ in tobacco duty. Our overall assessment of likely illicit growing activity is 295 tonnes in Australia. This represents tobacco duty of \$261 million.

Table 2: 2017–18 estimate of the size of domestic chop-chop cultivation

Gross \$m	Seized \$m	Net \$m
261	87	174

⁷ Tax Gap apply an average excise rate over the financial year not the actual point in time excise rate. This results in a discrepancy, as outlined in 2017-18, where domestic crop seizures are valued at \$87 million in the tax gap and \$90 million in table 2 above, where each seizure is calculated on current excise rate.

Step 3: Analyse the licensed warehouse system

6. This step involves analysing the licensed warehouse system. Customs duty on tobacco products may be applied directly at importation. However, for the majority of tobacco imports, the customs duty is deferred until it exits the licensed warehouse system. Tobacco is classified as ‘underbond’ while it is held in the warehouse system – that is, with no duty yet applied. Duty is collected on these products as they exit the warehouse system and enter into home consumption. ‘Leakages’ occur where tobacco that has entered the warehouse system exits without tobacco duty being paid.
7. Our analysis suggests that around 222 tonnes of tobacco was unaccounted for. A portion of this may be due to keying errors affecting data quality and the complexity of the warehouse system. The system features several classes of movement permissions, which can make precise reconciliation difficult. However, despite allowances for complexity, we cannot rule out that a portion of this was due to leakage. We estimate around \$196 million tobacco duty was lost through leakage of tobacco from the warehouse system for 2017–18.

Table 3: 2017–18 estimate of the licensed warehouse system

Gross \$m	Seized \$m	Net \$m
196	–	196

Step 4: Compare total illicit amounts to legal clearances

8. In this step we compare total illicit amounts to legal clearances of tobacco. Combining the estimates from step 1 to step 3 arrives at the total of illicit tobacco from all the supply channels in Australia. The total of \$1,094 million is the amount theoretically subject to tobacco duty in Australia for 2017–18.

Table 4: Combined estimate of illicit tobacco from all supply channels

	Gross gap \$m
Illicit importation	637
Domestic chop-chop	261
Warehouse system	196
Total	1,094

Step 5: Deduct compliance and seizures to determine net gap

9. This involves deducting the total of ATO and ABF compliance activities and seizures of illicit tobacco to determine the net gap. These activities include seizures across the sea and air cargo channels, international post, and domestic crop destructions. Around 505 tonnes of tobacco was seized and destroyed in 2017–18, with an estimated duty value of \$447 million.

10. Legal clearances of tobacco represented \$11.90 billion in 2017–18. Adding the illicit amount of \$1.09 billion to the legal clearances gives an estimate of \$13.0 billion, which is the theoretical amount of total tobacco duty in Australia for 2017–18.
11. This results in a tax gap estimate of \$647 million, or 5.0% of the total market for 2017–18.

Table 5: Deduct compliance and seizures to determine net gap

Gross gap \$m	Seized \$m	Net gap \$m	Tax paid \$m	Theoretical value \$m	Net gap %
1,094	447	647	12,361	13,008	5.0

