The Mechanics and Effects of MTIC Fraud

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Preface

Working as a project manager in a department totally dedicated to VAT, I understood the major importance that VAT has in the economy and the serious struggles that it is currently facing. In order to keep abreast of legislative changes and of recent developments in the area of VAT, our company organizes monthly update meetings in which we discuss about significant ECJ cases and other relevant topics. I decided to conduct a more in-depth analysis of MTIC fraud as this issue was raised during numerous of our monthly VAT knowledge update meetings. I realized that it was a topic of utter importance and that finding solutions to combat this fraud is essential for the future of the VAT system.

In addition to that, before joining the VAT team within my current company, I was also a trainee in the European Commission and that period enabled me to get a very good understanding of how the pieces of European wide legislation are drafted and approved. As a result, it was very interesting for me to follow and analyze the legislative framework related to the MTIC area.

As the topic is receiving continuous attention from the side of the authorities and the researchers, this thesis is mostly based on releases of the European Institutions, e.g. European Commission Communications. It is thus a product of secondary research, trying to put together the professional and scholarly research with the steps taken by and the suggested solutions of the European Institutions. In addition to that, the thesis comprises an overview of important Court cases which I considered relevant towards putting in practice the theoretical principles and which are usually referenced within the area of MTIC fraud.
Executive Summary

While VAT is functioning very well in the domestic settings, its application beyond the borders of each Member State can be flawed and can result in unwanted fraud. One of the most common types of cross-border fraud is MTIC (Missing Trader Intra Community). Within this type of fraud, if the same supplies travel multiple times across the same borders through the same supply chain then the more specific name for this MTIC fraud is carousel fraud. It is important to acknowledge the fact that MTIC fraud is not restricted only to goods but it can also affect tradable services.

Within the transitional destination-based VAT collection principle, it is very difficult for the authorities to keep track of all the transactions happening across their borders. Therefore, several zero-rated transactions and their correspondents may lead to VAT evasion by enabling companies to receive high VAT amounts from the purchasers and then to disappear before remitting these amounts to the state authorities. It is very difficult for the tax authorities to estimate precisely the VAT losses due to MTIC, but they are noteworthy and they lead to heavy VAT losses.

This thesis sets to determine methods of detecting, avoiding and fighting MTIC fraud. First, several significant Court cases are meant to highlight how MTIC takes place in practice and how the Courts look upon these facts in order to emit their decisions. Further on, numerous solutions against MTIC fraud are clearly detailed and assessed from an advantages / disadvantages outlook. The most prominent ones are the reverse charge, the joint and several liability and the knowledge test. In addition to these, several technological alternatives such as RTvat, VLN and D-VAT are also taken into consideration. To end this series of solutions to MTIC fraud in the current VAT system, a couple of alternative VAT regimes such as VIVAT and CVAT are also detailed and analyzed.

The concluding remarks are that MTIC has been treated very seriously both from the part of the tax authorities and from the part of the European Union. The solutions against MTIC fraud are plentiful but their downsides are that they might generate high implementation costs, might impose high administrative burdens or might even move this fraud into other categories of goods once applied to the affected cases.
1. Introduction

1.1. Background

Value Added Tax is an important source of revenue for the economies. It affects each individual’s day to day financial transactions and it automatically brings income to the governments. Within the European Union, businesses deal with numerous VAT obligations in different states due to the particular regulations of trade within the Union.

VAT fraud can take different forms among which one can mention the black economy and the missing trader Intra Community (MTIC) fraud. These fraudulent activities impact the economies of both the particular Member States in case and of the European Union. Despite the fact that the missing trader fraud normally involves a limited number of agents, the generated VAT losses are noteworthy. In addition to that, this type of fraud alters competition as the agents who do not pay VAT are able to sell products at lower prices than their peers. Putting an end to the missing trader fraud is a priority for both the European Union and the Member States. Nevertheless, despite the efforts made, this type of fraud is becoming more and more intricate.

One of the key issues that the European Union is currently facing is how to best run a destination-based VAT system in the absence of border controls. The aim of this study is to provide a comprehensive explanation of the functioning of MTIC fraud and to highlight solutions to this evasion. In order to achieve this, the study begins by introducing the readers to the world of VAT by identifying and defining all the relevant terms. As we move on, the study explains the functioning of MTIC fraud and the components of the current VAT system that allow for MTIC fraud to exist. It also highlights the economic impact of this type of fraud, both from a financial and a strategic standpoint. Further on, the study details methods of detecting MTIC fraud and examples of Court cases that are central for subsequent cases and decisions. Finally, an in-depth analysis is performed in order to evidentiate solutions against such fraud (ranging from slight alterations of the current VAT regime to totally new regimes).
1.2. Method

As it is a relatively new topic, there is not so much literature dedicated to MTIC fraud. Therefore, in terms of the method used, the study is mostly based on pieces of legislation and Communications released by the European Institutions and on Court cases. Nevertheless, it also looks into research conducted by prominent researchers in this field and published in reliable journals.

1.3. Research Question and Delimitations

The purpose of the current study is to offer a thorough explanation of the functioning of MTIC fraud and to detail and evaluate the suggested solutions to this problem.

It is important to keep in mind that the current study is only limited to MTIC fraud and that the other types of VAT fraud fall outside of the present scope. In addition to that, missing trader fraud that extends outside the borders of the EU (MTEC) is also not within the current scope.

2. Basics of the Value Added Tax

2.1. Introduction to VAT

VAT, the short version of Value Added Tax was initially introduced in Europe in 1954, in France. Following this, in 1967, the Member States of the European Economic Community (as it was called at that point in time) assented to substitute their national turnover taxes to a common VAT procedure. Within the European Union, Value Added Tax is a consumption tax to be applied to the value added to goods and services. It is collected at each step of the production and distribution chain and finally paid to the revenue authorities by the seller of the goods / services. By the process of deducting VAT paid for supplies and of adding up the VAT collected from customers, the final consumers are the actual payers of this tax. In other words this tax is not a burden on the companies, as it is just neutral to their business and finally paid by the consumers. It can also be said that the businesses are acting as unpaid tax collectors.

A more detailed look at the history of VAT would reflect that VAT was set up in April 1967 in the European Economic Community through the Directive 67/227/EEC, and was meant to tackle the market distortions of

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1 COM(2010) 695 final
2 DG TAXUD webpage, General overview of VAT
indirect taxes applicable on the full value of transactions. On May 17th 1977 the Sixth VAT Directive set the stage for a uniform VAT treatment. On January 1st 2007, this Directive was substituted by the VAT Directive (Directive no. 2006/112/EC). The new regulation does not impose specific rates on the Member States and it also permits certain exceptions and derogations by means of reduced rates.

VAT applies to the majority of goods and services that are sold or bought within the European Community. As a consequence the goods going for export or the services sold to clients abroad should not normally be assessed for VAT. In the case of imports they do get taxed in order to ensure similar competition conditions for EU producers and those outside of EU.

The purpose of VAT is to ensure transparency and fair competition in between the products offered by the Member States. Before the introduction of this concept, the taxes assessed by the Member States were not clearly traceable and could have easily led to export subsidies by overestimating the taxes refundable on exportation. The attainment of the objective of establishing an internal market presupposes the application in Member States of legislation on turnover taxes that does not distort conditions of competition or hinder the free movement of goods and services. It is therefore necessary to achieve such harmonization of legislation on turnover taxes by means of a system of value added tax (VAT), such as will eliminate, as far as possible, factors which may distort conditions of competition, whether at national or Community level.

2.2. Methods of Computing VAT

There are three methodologies for computing the due VAT.

- **The addition method.** In this case, the tax liability equals the tax rate multiplied by the value added defined as the sum of wages and profits. In other words, it is the sum of the rates on profits*profits and the rates on wages*wages. This could be seen as an additional layer of tax burden on top of corporate and personal income taxes but it could also, in theory, be used to substitute both personal income tax and corporate income tax.

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3 Borselli, F. (2011)
5 Le, Tuan Minh (2003)
• **The subtraction method.** At any step, the tax liability equals the tax rate multiplied by the tax base or value added measured as the difference between the values of outputs and inputs.⁶

• **The invoice-based credit method.** It is the most used method of assessing VAT and it assumes that companies charge their customers VAT at each step of the production-distribution chain. They afterwards submit the tax to the national treasuries and get back the VAT paid on their inputs.

This invoice-based credit method will be the benchmark of this study, while the other two were only presented for informative purposes. Below, a scheme which shows the VAT cycle, how the tax is collected at each point in the supply chain before it reaches the final consumer of the goods or services. Obviously, the scheme comprises a limited number of taxable persons involved in this delivery. In practice, the cycle could be much longer or even shorter.

A further analysis of the above scheme reflects the fact that if there was no deduction of the input VAT then it would become a selling cost for the taxable seller instead of being a burden for the final consumer. As it

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⁶ Le, Tuan Minh (2003)
currently manifests, the taxable persons receive VAT on their sales but when remitting this VAT to the Member States they deduct the portion of VAT that was paid on their acquisitions.

Finally, VAT is a very important source of revenue for the national budgets of the Member States. In numbers, the weighted average percentage of VAT within the GDP of each Member State of the European Union was in 1995 of 6.6% of GDP for EU-27, 6.5% of GDP for EU-17 and 6.6% of GDP for EU-25 while in 2010 it reached 7.0% of GDP for EU-27, 6.9% of GDP for EU-17 and 7.0% of GDP for EU-25. The percentage has been relatively constant along these years, showing that VAT is a reliable and important source of revenue. At a European Union level, part of the VAT collected by the Member States has as final destination the European Community’s budget. This is one of the reasons why there is a continuous process of harmonizing the tax rates and exemptions. Currently, with all the differing rates the system is very feeble to fraud.

2.3. VAT Specific Terminology

In order to facilitate the process of understanding the functioning of the VAT process and eventually the missing trader and the carousel fraud that will be explained in the subsequent chapters, it is very important to become familiar with the typical VAT terms.

A taxable person is an individual, partnership, company or suchlike that provides taxable goods and services within his business. It can be said that taxable persons perform economic activities. The economic activity refers then to the ‘exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis’. Depending on the Member State and its threshold, some companies do not have to charge VAT. ‘States, regional and local government authorities and other bodies governed by public law shall not be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with those activities or transactions’. Nevertheless they can still become taxable persons when, treated as non-taxable persons, their activities or transactions would distort competition.

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7 DG TAXUD & Eurostat, *Taxation trends in the European Union*
8 European Parliament Factsheets, *Value Added Tax (VAT)*
9 DG TAXUD webpage, *General overview of VAT*
Taxable transactions comprise the supply of goods, Intra-Community acquisition of goods, supply of services and importation of goods. In main lines, the supply of goods refers to the transfer of the entitlement of disposing of tangible property as an owner.\textsuperscript{12} The Intra-Community acquisition of goods refers to disposing of goods in a different Member State than the one where the dispatch or the transport of the goods began. The supply of services comprises any transaction that does not fall in the category of supply of goods. Finally, the importation of goods covers the goods, not in free circulation, that enter the Community and the goods, free in circulation, that are coming from a third territory part of the customs territory of the Community.\textsuperscript{13} The VAT on imported goods is to be paid at the moment the goods are imported.

The VAT taxation steps refer to the fact that VAT is charged on the products sold but the taxable person has the right to deduct all the VAT paid on his purchases.

The VAT rates differ from one Member State to another. They however need to respect the following: standard rate should be of at least 15\% while the reduced rate should be of at least 5\%.\textsuperscript{14} Zero rating implies that VAT is not charged for exported goods and the VAT paid on the inputs of those goods is deductible.

In conclusion, what is important to remember is that a taxable person can deduct VAT from a transaction only after it has been subject to VAT in the first place.

\section{2.4. The International VAT Regime}

\subsection{2.4.1. Introduction}

Due to the fact that alongside the domestic transactions there were also transactions taking place in between the borders of the Member States, it became vital to decide on the taxation principles of such operations. Initially, before 1993, the EU adopted a temporary approach of taxing the supply of goods in between taxable persons according to the ‘destination’ principle, meaning where the goods were consumed. Imported goods used to be taxed at the borders under the control of the customs authorities and a VAT credit used to the offered for the goods entering the production cycle. The VAT on exports would also be refunded while

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\begin{itemize}
\item \textsuperscript{12} Council Directive 2006/112/EC
\item \textsuperscript{13} Council Directive 2006/112/EC
\item \textsuperscript{14} DG TAXUD webpage, General overview of VAT
\end{itemize}
the border authorities could check whether the goods did indeed leave the country. Through the creation of the single market in 1993, the controls at the fiscal frontiers were eliminated. With the open frontiers, the new proposal was to use the ‘origin’ system, meaning taxing the goods where they were supplied. This suggestion was not welcomed by the Member States as they considered their VAT rates too dissimilar and there was no proper mechanism to reallocate the VAT receipts in order to reflect the actual consumption.\textsuperscript{15} Because of that, the Commission set forth the ‘Transitional VAT System’ which accepts different fiscal systems but keeps the controls at the frontiers abolished. This transitional system comprises both approaches as it differentiates the sales to private and taxable persons. In other words, private persons would pay the tax anywhere in the Union and could bring goods to their home country without needing to pay other VAT (certain exceptions apply as for the purchase of new means of transport and distance selling).\textsuperscript{16} Taxable persons still use the destination system and have to provide the VAT numbers of their customers that are located abroad so as to be eligible for the VAT rebate that they are claiming. Thus, the customs control has shifted from the physical control of goods at the country borders to an accounting control. These taxable persons need to include a self-assessed VAT and also include a credit at the same time so as to result in no VAT payable or receivable (except for VAT exempt traders).

This mechanism is motivated by concerns on the side of the high VAT countries that they would lose their industries against the low VAT countries. In the future, the Commission would still like to adopt the origin based system for all the categories of persons through its ‘Definitive System’. This definitive system would eliminate the export rebates within the EU in order to make firms completely neutral within the Single Market. Nevertheless, none of the many proposals drafted by the Commission were enacted into law and there is no success in sight for such an approach to the VAT system.

The Intra-Community trade occurs on a zero-rated basis. The Commission wanted to introduce a clearing house in order to ensure that the tax collected in the Member State of supply would be paid in the Member State of import (where it was deducted). In other words, the Intra-Community exports would be taxed at the VAT rate of the exporting Member State, the amount would be charged to the importer and the importer would then get a credit against his VAT liability incurred on his sales. To make this fully functional, the importing state would consequently need to reclaim the VAT credit granted to the importer from the

\textsuperscript{15} DG TAXUD webpage, \textit{General overview of VAT}
\textsuperscript{16} DG TAXUD webpage, \textit{General overview of VAT}
exporting state. By following this mechanism, the states would only have to settle the VAT amounts that were collected by the exporters over the VAT credits on imports. This proposal was however rejected due to beliefs that the Member States of purchasing would not do the effort to collect information with regard to money that would be paid to other Member States. The importing Member States might lose the incentive to track down fraud as long as the VAT claims were covered by the exporting states, while the exporting states might become less motivated to look for fraud in the failure to charge VAT on exports. Therefore the zero-rating system was chosen. According to this system, an exporter does not charge VAT but can claim a refund of VAT; a buyer would not pay VAT but would charge it during his sales and would pay it to the VAT authorities.

In case of an Intra-Community acquisition of goods, the Member State in which the dispatch or transport of goods ends is the one who can apply taxation no matter the VAT treatment applied to the transaction in the Member State from which the goods originate.\(^\text{17}\)

Finally, in order to give a full coverage of the VAT system, it is also worth taking a look at the Intra-Community trade of the exempt entities. The goods and services that they provide are not subject to VAT when sold but the companies cannot reclaim the VAT paid on the purchases of the inputs needed in the production process. These entities need to self-assess the Intra-Community acquisitions, a step that would be redundant if they were also VAT registered. As a general concept, the VAT exemptions are a hindrance to the VAT process as they interfere with the logic and application of this system. They basically interfere with competition in the market of similar goods as they favor exempt firms over non-exempt when selling to final consumers and they favor non-exempt firms over the exempt when they sell to other traders (as the non-exempt ones can claim back their input costs). One example would be the case of public television and private broadcasters. One last aspect, the exemption aspect of VAT can also increase the compliance burdens and the risk of fraud when companies perform both type of activities and need to apportion the input VAT to both the taxable and exempt sales.

\(^\text{17}\) Council Regulation (EC) No 1777/2005
2.4.2. VAT Principles

Even though the value added taxes differ across the globe (in some areas the term even becomes GST, standing for Global Tax and Services), there are several principles that keep these taxes on a similar direction.

It is important to keep in mind that only the value added can be taxed. On this account, the VAT mechanism obeys the **reciprocity** rule which states that the input VAT for the seller needs to be equal with the output VAT of the buyer.

**Neutrality** is conserved by the fact that no matter the type of good / service, no matter the length or structure of the supply chain, the VAT is charged in a similar way and to the final consumer. The destination principle advocates the idea that exports need to be free of VAT and imports should be taxed similarly to the local production.\(^{18}\) If this principle is not respected then one can encounter either double taxation or a lack of taxation.

The destination principle is the opposite of the origin principle which states that each state would charge the VAT on the value created within its territory. This would translate into exporting countries taxing exports similarly to their domestic supplies and importing counterparts would allow a credit against their own VAT to balance the theoretical tax that was paid at the country’s importing rate. This method would resemble to a higher extend the domestic transactions. However, this method would also mirror the mixed rates applied in each of the countries in the supply chain. Another issue affecting the destination principle is the fact that while goods can be taken into evidence during the border control, the situation becomes more complicated in the case of services and intangible products. Since no border controls can take notice of the circulation of the latter examples, there have been special rules designed. These rules depend on the type of the service and of the regulation of each country.

2.4.3. VIES (The VAT Information Exchange System)

VIES is a system which helps the national authorities to ensure that traders follow the VAT Directive. The registered companies need to report the Intra-Community supplies (exports) made to registered firm in other

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Member States by mentioning their respective VAT numbers. This is done through ESL (European Sales Listing) reports which are mandatory reports for all the VAT registered traders. VIES helps control the zero-rated flows that take place from one Member State to another. VIES also helps the Member States identify the non reported intra Community supplies and allows for confirmation of any VAT registration number (for companies registered in the EU).\(^\text{19}\) It basically matches the Intra-Community acquisitions per trader with the supplies reported individually. VIES uses as input the information gathered by the national administrators from their national databases which is pushed into a central data bank. This data is maintained real-time as the requests to validate VAT numbers are sent directly from the website to the Member State in case.

The Intra-Community supplies declared on 'recapitulative statements' are also captured in VIES. These recapitulative statements are submitted to the tax administration of the taxable person making the supply. Recapitulative statements occur when ‘taxable persons making the Intra-Community supplies report the total supplies in the relevant quarter to each taxable person in another Member State’.\(^\text{20}\)

The information included in ESLs is also used in order to avoid that domestic trade is considered as zero-rated dispatches by the traders in case. In cases when the tax authorities have received false information with regard to the VAT status of the partners of traders, they will pursue the traders and will try to recover the VAT from them. Due to the fact that taxable persons that are not performing an economic activity or missing traders are still in VIES, there is the risk of fraud.

In addition to VIES, there is an additional statistical data collection mechanism which is called Intrastat. Intrastat gathers information about the trade of goods in between the Member States. Despite their intended use in detecting fraud, the two systems may generate higher compliance costs for businesses performing Intra-Community trade which could in turn lead to trade competition inequalities.

3. The Mechanics of Missing Trader Fraud

The case of fraud with missing traders can happen at different scales and within different geographical borders. Even though the focus is of MTIC (Missing Trader Intra Community) fraud, it is also worth

\(^{19}\) DG TAXUD webpage, VIES FAQ
\(^{20}\) DG TAXUD webpage, VIES FAQ
mentioning the existence of MTEC (Missing Trader Extra Community) fraud. MTEC fraud takes place when businesses perform extra-community purchases (imports) of services for which they pay no VAT, they collect tax for the further sale of the services and afterwards they evaporate without remitting the collected tax to the authorities.\textsuperscript{21} Thus, as compared to MTIC, MTEC fraud only occurs with tradable services as for goods there are customs monitoring the cross-border trade.

MTIC fraud builds on the fact that cross-border transactions within the EU are zero-rated for VAT. In other words when importing goods there is no VAT to be paid but the importers will charge VAT when they conduct the subsequent sale of these goods. If these importers do not declare and do not pay the relevant VAT to the authorities then this becomes a case of Missing Trader Fraud. Within this general category one can discern two segments: acquisition fraud and carousel fraud.

Acquisition fraud takes place when a trader imports goods or services from another Member State, he doesn’t pay VAT but he collects VAT when he sells these to a domestic customer and he finally disappears without paying the collected VAT.\textsuperscript{22}

If this illegal activity happens multiple times then it falls into the category of Carousel Fraud. In other words, the same goods are supplied in a circular fashion. Even though the missing trader does not pass on the VAT collected to the authorities, the players at the end of the supply chain will claim back the input VAT paid. By practicing Carousel Fraud, with each cycle of the goods, the persons in case deprive the fiscal authorities of their Member States of the VAT that they should rightfully collect for the supply. As is the case with acquisition fraud, also in carousel fraud the missing trader normally offers a lower price to his customers.\textsuperscript{23}

The principal objective of the missing trader is to obtain a huge turnover and to charge / collect the greatest amount of VAT possible in a short time frame.\textsuperscript{24} It may look that several transactions are actually triggering a profit loss but in reality the deceptive trader adds the amount of VAT to his profit margin.\textsuperscript{25} Finally, it is

\textsuperscript{21} Ainsworth, R.T. (2010b)
\textsuperscript{22} HMRC website, VATF23300 - What is VAT fraud?: Examples of different types of VAT fraud: Missing Trader Intra-Community (MTIC) fraud
\textsuperscript{23} Borselli, F. (2011)
\textsuperscript{24} Wolf. R.A. (2010)
\textsuperscript{25} Wolf. R.A. (2010)
important to keep in mind that carousel fraud takes place mostly in relation to high value / low weight goods as they are valuable, easy and inexpensive to transport.

MTIC fraud can happen at a very large scale. Organizations especially set up to take advantage of such tax loops would make use of outside individuals, promising them quick returns and asking them to set up short-lived businesses and then disappear. As a result, when uncovering and punishing the missing traders, the fraud is only addressed from a somewhat superficial layer, as the big organizations will go on finding other candidates to help them set up further evasion schemes.

The intention of fairly collecting VAT at each step of the sales chain increases the risk of evasion. The goods have to pass through numerous transactions that need to be recorded. There is therefore a kind of tradeoff that the states need to undertake, not be too restrictive (and deny legitimate VAT recovery claims) but also not be too weak and allow fraud.


The typical steps are the following: Company A sells goods to Company B (also known as ‘missing trader’). Company B does not pay any VAT on these goods and makes a domestic supply to Company C (‘also known as ‘buffer’). Company B collects VAT through this sale but does not pay any VAT to the authorities and disappears. Company C claims a VAT refund on its purchases from B. Afterwards, Company C will declare an exempt intra community supply back to Company A and the cycle will be restarted. The loss for the authorities consists of the VAT paid by Company C to Company B. The minimum requirements for such a fraud consist of at least three traders (one needs to be in another Member State); a flow of invoices in between them; a trader charging VAT but not paying it back to the relevant authorities.

The missing trader normally has a very short existence (a few weeks or months) and can move its place of business abroad, it can also hijack VAT numbers (buy goods from abroad by using other businesses’ VAT numbers and putting them at risk of getting penalties for the acquisition of goods that they participated in).\(^\text{27}\)

Carousel fraud may go through numerous intermediaries which are called ‘buffers’. It is possible for some of the buffers not to be aware that they are involved in such a scheme, however in most cases, they are knowledgeable that it is an abnormal transaction.\(^\text{28}\) Their role is to complicate the chain and to make the fraud harder to trace. There are also additional players that could be involved in such transactions:

- Carriers: transport or pretend to transport the goods and they also supply logistical bases;\(^\text{29}\)
- VAT warehouses: stock up the goods purchased in “tax suspension”;\(^\text{30}\)
- Law firms: help set up and liquidate the companies.\(^\text{31}\)

There are a couple of pointers that could enable businesses to suspect that their trading partners are involved in MTIC fraud\(^\text{32}\):

- The business is new, relatively big and is run by young people with no past record in the mobile phone or computer industries. It is highly unlikely that they could maintain such a business by lawful means.

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\(^{27}\) Borselli, F. (2011)  
^{28} COM(2004) 260 final  
^{29} Borselli, F. (2011)  
^{30} Borselli, F. (2011)  
^{31} Borselli, F. (2011)  
^{32} Needham, A. (2006)
• The business has changed completely from its initial scope and it is now generating very high revenues dealing with MTIC fraud prone products. This is a sign that it has been taken over by new owners.
• The business’ turnover has increased unrealistically, quickly reaching very high values.
• The business has constant profit margins with a very high one when dealing with exports.
• The business is buying from the Netherlands, Spain and France, or selling to Dubai or Hong Kong which are common starts and ending point to such fraudulent chains.
• The business is generally trading with businesses which have a low number of employees, have no track record and have only recently started to trade (very little repeat business).
• The business is financed by doubtful sources such as remote family members which contribute with very high loans.

In general, companies should pay much attention to both the company that they are trading with and to the goods that are at stake. For example, the confirmation that a VAT number does exist does not mean that the trade is safe as that VAT number could have been hijacked. Therefore one should pay close attention to indicators that the counterparty of the trade is not the one who is registered. In addition to that, goods at very advantageous prices may be the forefront of fraud. That does not mean that businesses should ignore good trading opportunities but they should be very careful and look into all the details of the exchange.

Carousel fraud can also appear in the case of trade with countries outside of the EU. The goods enter the EU through one Member State and are destined for another state. However during the transportation process they get separated into smaller batches and their original source is hidden. They travel duty-free within the Union and the customs tariff is not paid.

Based on the updated regulations whereby the business to business supplies of services are taxable in the country of “destination” (the place where the actual consumption takes place, with some exceptions) and the business to consumer services are taxed in the country of the supplier (“origin principle”), the amount of services supplied at a distance has grown significantly. This principle has given rise to fraud schemes involving purchasing services from abroad under the reverse charge mechanism. Moreover, taxable persons

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33 Borselli, F. (2011)
can now engage in fraud that becomes extremely hard to identify as they offset their legal VAT liabilities (from services) with illegal transactions of goods.  

Missing trader fraud appeared at the same time with the introduction of the VAT system. As examples of early fraud, in France at the beginning of this system (1954), criminal organizations were collecting scrap iron for free or from private individuals. They then sold this iron to the steel companies with VAT which the scrap dealers did not pay back to the authorities. When the authorities traced these frauds, they would also find dead the tramps that had originally issued the related invoices. The response from the side of the authorities was to treat the sale of scrap iron as being out of the VAT scope. In other words, the steel companies could no longer deduct the VAT not paid by the traders. In the Netherlands the first VAT carousels date in the 1970s, under the Benelux regime. The VAT due on the importation of goods from Belgium or Luxembourg was not paid to the border customs officials but had to be accounted through a periodic VAT return through which a trader could also deduct the same amount of input VAT. Thus, traders in the Netherlands could acquire ‘VAT-free’ goods from Belgium and sell them with Dutch VAT in the Netherlands without paying the collected VAT to the authorities.

Carousel fraud is not restricted to goods even though the general principle involves the resale of a supply that was acquired without VAT. Cases of carousel fraud related to services have also recently started to evolve as several services can be bought and resold as in the case of goods. The so called tradable services are somewhat similar to goods (from a commercial point of view), have functional characteristics that make them hard to distinguish from services but are dissimilar from their counterparties, the consumed-on-purchase services. Consumed services include a wide array of items such as restaurant meals, hairdressing etc. which are normally consumed by the first purchaser and are seldom resold. Tradable services are originally created for resale and establishing their place of supply (taxation) can become difficult due to this dual character.

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34 Borselli, F. (2011)  
35 Amand C. and Boucque, K. (2011)  
38 Ainsworth, R.T. (2010b)
One example refers to the greenhouse gas emission allowances which started being spotted in late 2008. On October 2003, the European Parliament and the Council established several rules in relation to trading greenhouse gas emission allowances. By trading CO2 permits, the Directive was meant to follow the UN Framework Convention on Climate Change and the Kyoto Protocol so as to decrease the greenhouse gas emissions by 8% relative to the 1990 levels.\(^{39}\) The system was introduced as of January 1\(^{st}\), 2005 and did not allow industrial operations to take place without the installation operator having permits granted by the authorities. Each operator needs to surrender allowances equal to the total emissions of the installation in each calendar year and one emission allowance conveys the right to emit one ton of carbon dioxide.\(^{40}\) For each Member State there is an allocation plan and the Member State needs to allot emission certificates to the operators within its territory. What is important to keep in mind in order to understand the fraud is that emission allowances are mutually recognized and transferrable in between the states (both within and outside of the EU). Following the theory, the businesses following more outdated technologies would require more certificates, while the businesses using more efficient processes will receive fewer certificates. As the greenhouse gas emission allowances are tradable services, they need to be taxed with VAT. On these grounds, they become tradable services that can give rise to the missing trader type of fraud.

The means of spotting the fraud with greenhouse gas emission allowances was that some market platforms experienced a record increase in the trade volume of European Unit Allowances (EUAs) in 2008. In May 2009, the market volume reached a maximum when some hundred million EUAs were traded in e.g. France and Denmark.\(^{41}\) However this was rapidly tackled as France, the Netherlands and the UK changed their taxation practices with respect to such transactions and their market volume decreased by up to 90%.\(^{42}\) In practice, fraudsters acquire VAT-free quotas abroad and afterwards sell these in the country by also charging VAT to their clients. Before the moment of remitting the VAT to the authorities, the fraudsters liquidate their businesses. These allowances encompass big amounts of money and have a high mobility as they are sold on specialized markets.\(^{43}\) In this carbon market, the fraudsters make use of phishing scams by getting an account holder’s user name, password and any other necessary information to access on-line registry accounts and

\(^{41}\) Europol press release, *Carbon credit fraud causes more than 5 billion Euros damage for European taxpayer*  
\(^{42}\) Europol press release, *Carbon credit fraud causes more than 5 billion Euros damage for European taxpayer*  
\(^{43}\) MEMO/09/423
afterwards to initiate a fraud under a false identity.\textsuperscript{44} In addition to the greenhouse gas emission allowances, frauds have travelled in recent years to dematerialized markets, by approaching the gas and electricity sectors.\textsuperscript{45}

Another example of MTIC fraud relates to VoIP (voice over internet protocol). VoIP is ‘a general term for a family of transmission technologies concerned with the delivery of voice communications over IP networks such as the internet’.\textsuperscript{46} Even though the market is led by retail demand, VoIP MTIC takes place in the wholesale market.\textsuperscript{47}

In order to understand how MTIC manifests itself in the VoIP environment it is important to understand how VoIP functions. In short, at the retail level (business-to-consumer) it has an origin and a termination function. At origin one person uses his internet connection and his broadband telephone adaptor, his headset or even his VoIP enabled mobile phone.\textsuperscript{48} His connection will be made through the internet to the receiver who is at the termination point. Services could be free if made from computer to computer but the main positive aspect of VoIP is that users can be reached on their phones or calls can be made from VoIP enabled phones (landlines or mobile phones). Wholesale normally happens for businesses. With global companies performing their activities in multiple countries, it is important to reduce the communication costs.

From a MTIC point of view, vendors facilitating this service trade minutes and equipment. The minutes are a commodity as it is important for the traders to get minutes that can be bought low and re-sold somewhat higher, while they are normally bought and sold for a fraction of a penny through highly competitive exchanges which function almost completely over the internet.\textsuperscript{49} The minutes can be sold by brokers or directly and the market is totally free from regulations but the VoIP services may be regulated according to the jurisdiction.\textsuperscript{50} As these are services, whenever they are sold from one Member State to another, reverse charge applies. Minutes traders can easily disappear without a trace. As the market is not regulated, there are

\textsuperscript{44} Borselli, F. (2011)
\textsuperscript{45} Borselli, F. (2011)
\textsuperscript{46} Ainsworth, R.T. (2010a)
\textsuperscript{47} Chau, F. (2007)
\textsuperscript{48} Ainsworth, R.T. (2010a)
\textsuperscript{49} Ainsworth, R.T. (2010a)
\textsuperscript{50} Ainsworth, R.T. (2010a)
no paper trails and as the minutes are used the transaction vanishes. Moreover, as minutes are stored on SIM cards or the paid-up time of a landline connection, they can be managed from any place and the fraud can be very neat. Finally, when fraudsters fade out, they would either leave behind only a termination box which can be located in the jurisdiction where the fraud took place or in foreign jurisdictions or they would not even own such a box as they are manipulating as brokers unaware and legitimate VoIP companies that are treated as buffers.

As mentioned above, the main issue with MTIC fraud for services is the fact that they disappear once they are used therefore they leave no traceable mark as in the case of goods.

4. Estimates of Revenue Loss

4.1. Tax Fraud

‘A VAT invoice [is] a check written on the government’. With this statement in mind, the tax authorities are very sensitive to fraud committed by the businesses acting within and beyond their jurisdictions.

Taking into account the numerous transactions going on at the European Union level, one can understand that there is a huge amount of invoices that the authorities need to keep track of. Within this web of transactions, fraud creeps in and the tax evasion reaches important levels. The tax gap, representing the total VAT that would have been collected had all the traders paid their corresponding VAT, can be quite substantial. However, not all of the missing VAT revenue is due to fraud, one should also take into consideration the part due to innocent mistakes or even legal tax avoidance. Nevertheless, the remaining part due to fraud can be categorized into the following two classes:

- Traders who understate the taxable sales and overstate their creditable inputs. This can be achieved by not recording the taxable sales and receiving directly the due cash, not registering for VAT even though the companies are liable to do it, falsifying invoices for input VAT, claiming zero-rated sales by falsifying the export invoices. In addition to that, fraudsters can also take advantage of the dissimilar VAT rates according to the transactions (consumption as opposed to business

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51 Ainsworth, R.T. (2010a)
52 Ainsworth, R.T. (2010a)
53 Ainsworth, R.T. (2010a)
54 Bird, R.M. (1993)
expenditure, inputs to exempt as opposed to inputs to non-exempt trade etc.). The results are partially normal and unavoidable in a VAT system and partially due to the uneven approach taken to the taxation of VAT.

- Traders who simply disappear without paying the due VAT. It mostly happens in the case of traders who build up high net VAT liabilities.

In the first case, one could also say that the VAT mechanism is somewhat properly designed to fight fraud for the seller needs to generate correct invoices as the buyer would further desire to claim back the VAT paid. In the second case, it could also be claimed that the system is designed in such a fashion that VAT is collected at each step and the VAT gains at each stage (including the last in our case) are not very significant. In addition to that, if the seller managed to indeed gain a high VAT amount on his value added then he would be motivated to remain in business as he is performing a high value-added activity. Finally, within the current scope, the firms highly motivated to dissolve are those that generate outputs by means of untaxed inputs (zero-rating).

Carousel fraud has also been suspected of being a means of laundering money and funding terrorism.\(^{55}\) However, there is no clear information about such purposes. Money travels fast and sometimes untraceable as the fraudsters have set up internet payment platforms which became a favorite method for moving the massive sums of money resulting from frauds.\(^ {56}\) These platforms ‘register on an exchange, hold a single large account with a traditional bank, but take deposits and make transfers for traders (normally for €500 when a traditional bank would charge €30 for an international swift payment)’\(^ {57}\). They are outside of the traditional banking monitoring, operate at the exterior of the normal channels and are quickly taken out from the internet in case of inquiries. Once one platform is closed, there are multiple others that can start up and takes its place.

4.2. MTIC Fraud in Numbers

VAT frauds are difficult to express in numbers due to the restricted availability and the incompleteness of the information. As there are no clearly centralized figures reflecting the level of tax fraud, the economic

56 Ainsworth, R.T. (2011b)
57 Ainsworth, R.T. (2011b)
literature estimates these amounts of tax fraud of 2 to 2.5% of GDP.\textsuperscript{58} At EU level, this would represent about 200 to 250 billion Euro, with about 10% (thus 20 to 25 billion Euro) due to VAT fraud.\textsuperscript{59} However the figures should only be used as general references as it is very easy to miss very specific types of fraudulent transactions (such as VOIP and other tradable services which extend beyond the borders of the EU).

There is a major interest on the part of the EU to fight against the VAT fraud and to ease the system. This is also reflected in the numerous communications and reports from the Commission, the Council and other European Institutions. Finally, the VAT fraud does not only impact the financial revenues of the national authorities but it also alters the competition in between the payers of VAT and those who escape the due VAT payments.

The general case in the Member States is that 80% of the VAT is paid by less than 10% of the existent taxable persons.\textsuperscript{60} This translates into an easier control on the side of the Member States so as to receive the majority of the VAT due.

Austria approximates its VAT losses due to fraud to about 4.4% of total VAT revenues (with no exact amount for the proportion due to MTIC fraud) while Germany approximates the MTIC frauds as accounting for a loss of around 2% of its VAT receipts.\textsuperscript{61} In Belgium, the estimated organized fraud for 2001 was of EUR 1.1 bn. and classic VAT fraud was of EUR 2 million.\textsuperscript{62}

The UK has put quite some efforts into estimating the loss in revenue due to fraud. It has published yearly researches which aimed to quantify the tax gap. Given the difficulty of this exercise and the fact that it is a fairly novel area in what concerns the work of the Member States, the data is continuously reviewed and reworked as new information and methods for assessment come into play. In general, the tax gap can be calculated by different approaches. The methods highlighted in the UK studies, comprise a top-down reconciled with a bottom-up approach. The first one, top-down, involves a difference in between the tax that was actually collected and the estimates of the HMRC with regard to the amount that they should have

\textsuperscript{58} MEMO/09/423  
\textsuperscript{59} MEMO/09/423  
\textsuperscript{60} COM(2006) 404 final  
\textsuperscript{61} COM(2006) 404 final  
\textsuperscript{62} House of Lords European Union Committee, \textit{Stopping the Carousel: Missing Trader Fraud in the EU}
collected. On this account, the tax gap loss is a product of fraud, mistake, nonpayment and artificial avoidance schemes. In order to assess the accuracy of this amount it is important to keep in mind the approach taken to obtain it. According to the UK studies\textsuperscript{63}, the steps are as follows:

- ‘assessing the total amount of expenditure in the economy that is theoretically liable for VAT
- estimating the tax liability on that expenditure based on commodity breakdowns of the expenditure data
- estimating the value of tax on the VAT-able expenditure, to derive the gross VAT theoretical tax liability (VTTL)
- subtracting any legitimate refunds (deductions), occurring through schemes and reliefs, to arrive at the net VTTL
- subtracting actual VAT receipts from the net VTTL and
- assuming that the residual element, the gap, is the total VAT Gap, including all losses, for any cause.’

The bottom-up method builds on operational and intelligence data so as to reconcile the top-down approach and to assign the losses to particular items. On this account it separates the gap into the following points\textsuperscript{64}:

- ‘General non compliance (under declaration of VAT liability due to error or failure to take reasonable care)
- Evasion (deliberate under declaration of VAT liability)
- Failure to register - hidden economy (VAT liability of traders that should be registered but are not)
- Avoidance and legal interpretation
- Debt contribution to the VAT gap
- Criminal attacks – MTIC (missing trader Intra-Community fraud) and VAT losses due to excise fraud.’

As it is quite hard to provide reliable estimates of all the items in the gap, according to the UK studies, the MTIC and the debt amounts are correct and reliable. MTIC fraud accounts for £0.5 billion to £1.5 billion while debt is responsible for around £1.8 billion of the VAT gap of 2009-2010.\textsuperscript{65}

\textsuperscript{63} HMRC, Measuring Tax Gaps 2009
\textsuperscript{64} HMRC, Measuring Tax Gaps 2011
Below several tables were adapted from reports released in March 2010, September 2011 and November 2011 and comprise different amounts for the same time periods. This stands to prove that the tax gap is very hard to estimate correctly.

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<td>78.7</td>
<td>82.5</td>
<td>86.2</td>
<td>89.5</td>
<td>93.5</td>
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<td>77.6</td>
<td>81.9</td>
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<td>11.9</td>
<td>11.5</td>
<td>14.4</td>
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<td>12.1%</td>
<td>11.8%</td>
<td>15.4%</td>
<td>13.3%</td>
<td>12.3%</td>
<td>15.3%</td>
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Released in March 2010; adapted from HMRC, ‘Measuring Tax Gaps 2009’, where the net VAT receipts are net of payments and repayments and part of the VTTL 2008-09 is a forecast.

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<tr>
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<td>78.6</td>
<td>82.5</td>
<td>86.1</td>
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<tr>
<td><strong>Net VAT receipts (£bn)</strong></td>
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<td>69.1</td>
<td>72.8</td>
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<td>11.6</td>
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<td>11.4</td>
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<tr>
<td><strong>VAT gap (per cent)</strong></td>
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<td>12%</td>
<td>11.7%</td>
<td>15.2%</td>
<td>13.5%</td>
<td>12.4%</td>
<td>15.5%</td>
<td>13.8%</td>
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Released in September 2011; adapted from HMRC, ‘Measuring Tax Gaps 2011’. The net VAT receipts are net of payments and repayments and part of the VTTL 2009-10 is a forecast.

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<td>78.2</td>
<td>81.3</td>
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<tr>
<td><strong>Net VAT receipts (£bn)</strong></td>
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<td>12.1%</td>
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<td>13.0%</td>
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<td>9.7%</td>
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HMRC, Measuring Tax Gaps 2011
Released in September 2011; adapted from HMRC, ‘Provisional VAT gap estimates: Official Statistics Release’. Again, the net VAT receipts are net of payments and repayments and part of the VTTL 2009-10 plus the whole 2010-11 are forecasts.

For the sake of accuracy, the VAT gap will be analyzed based on the latest version of the report. It is noticeable that it has been decreasing steadily from the 2002-03 estimates until the 2005-06 when it picked up. A high level look would depict a cycle that covers a three year period. It seems that the gap decreases for two consecutive years only to pick up during the third and start the cycle again. Unfortunately, at this point, there were no estimates of the 2011-12 amounts so as to see whether the cycle is repeating and if the VAT gap would record another hike after two years of continuous decrease.

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<tr>
<td><strong>Impact on VAT receipts</strong></td>
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<td>2</td>
<td>2</td>
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</table>


Looking at the amounts in the table above one can notice that the fraud attempts have been decreasing and afterwards fairly stagnated since the 2005-06 values. Nevertheless, they are still within the range of £ billion. Unfortunately, as mentioned in the HMRC’s study the estimates of the attempted fraud and their impact on the VAT receipts cannot be directly compared as certain frauds can only be assessed when they impact the VAT receipts. Moreover, HMRC claimed that the low amount mentioned for 2009-10 does not reflect a decrease of fraud but it is rather a rounding consequence.

Sweden has also tried to measure the tax gap in a report covering the year 2007 which was released in 2008. Not very detailed with regard to carousel fraud it does however encompass an estimate of its value within the total tax gap. In 2007 the Swedish National Tax Agency calculated the VAT gap on international
transactions to a value of SEK 11.8 bn. Converted in EUR, this amount would approximate to EUR 1275,462 million (by using a 2007 yearly average conversion rate of 0.10809\textsuperscript{66}). Within this amount, carousel fraud covered about SEK 1000 million which would again translate into EUR 108,090 million (by using the same conversion rate as for the total international gap).

Regrettably, not all the countries keep such extensive reports on the VAT losses or at least there are no English versions of similar reports. However, in order to get a feeling of the VAT gaps at the European Union level, the thesis will take into consideration the most recent study performed for the European Commission (2009) which highlights the VAT gap situation in the EU-25 countries for the years 2000 to 2006. The study uses a top-down approach by contrasting the VAT receipts with the tax liability computed based on the general economic information. However it is important to keep in mind that the study has several limitations due to the variability of the data taken into account on the grounds of specific national factors.

<table>
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<td>22%</td>
<td>20%</td>
<td>19%</td>
<td>19%</td>
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<td>EU-10</td>
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</table>

Adapted from Reckon LLP, for DG TAXUD, ‘Study to quantify and analyse the VAT gap in the EU-25 Member States’. The EU-10 and EU-25 amounts do not take Cyprus into consideration. The column ‘VAT gap as share of liability’ refers to the theoretical liability. Amounts in £ billion.

One can observe that the maximum share of the VAT gap as compared to the theoretical liability was of about a fifth and was recorded at the level of the EU-10 in the 2000 to 2004 period. At the level of the EU-15 and the EU-25, the percentage seemed to stay quite constant, ranging in the area of 12% to 14%.

\textsuperscript{66} FX, Average exchange rates website
### Estimates of the VAT gap, 2006 (EUR million)

<table>
<thead>
<tr>
<th>Member State</th>
<th>Theoretical VAT liability</th>
<th>VAT receipts</th>
<th>VAT gap</th>
<th>VAT gap as a share of theoretical liability</th>
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<td>19,735</td>
<td>3,108</td>
<td>14%</td>
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<tr>
<td>BE</td>
<td>25,360</td>
<td>22,569</td>
<td>2,791</td>
<td>11%</td>
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<tr>
<td>CZ</td>
<td>9,216</td>
<td>7,541</td>
<td>1,675</td>
<td>18%</td>
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<td>DE</td>
<td>164,115</td>
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<td><strong>800,955</strong></td>
<td><strong>106,712</strong></td>
<td><strong>12%</strong></td>
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Adapted from Reckon LLP. for DG TAXUD, ‘Study to quantify and analyze the VAT gap in the EU-25 Member States’. The EU-25 amount does not take Cyprus into consideration. All the currencies were converted to EUR based on the average exchange rate in 2006.
Based on the study, there is no general trend with regard to the estimated VAT gap of the 24 Member States under analysis during the period 2000 to 2006. However the study does show that for most of the countries there has been a descending trend and the decreases seem steeper for the period 2003 to 2006. This trend applies not only to the new countries that joined the EU in 2004 but it is most evident at their level.

In addition to the macroeconomic method used for the above examples, the tax gap can also be calculated by means of a microeconomic approach. This is however more difficult to use due to the restrictive character of the data access (only the tax administrations have the detail of data needed for such a method). There are two methods that build on the international databases (such as VIES)\textsuperscript{67}:

- Mirror flows, basically a data cross. Information from two Member States is compared in order to see whether the declarations made on each side match, and, if not, to identify what is missing and would therefore be part of fraud.
- Profiling. A technique similar to mirror flows where the profiles are detected individually by the models, then aggregated in order to evaluate the weight of each fraud profile.

In terms of services, trade in emission certificates resulted in losses of about 5 billion euros since the middle of 2008 to the end of 2009 and, in several countries, up to 90% of the whole market volume was brought about by fraudulent activities.\textsuperscript{68} In Germany the amount was of EUR 850 million, while in Italy of EUR 500 million.\textsuperscript{69} As it concerns Belgium, the VAT losses were of about EUR 79 million, amounting to around 85% of the full volume of organized VAT fraud in the country.\textsuperscript{70}

In conclusion, I believe that the MTIC fraud estimates should be looked at as a general idea rather than as specific, all-inclusive numbers. Even though the estimation methods are reliable, MTIC is many times hard to uncover and, thus, there is a high possibility that numerous fraudulent arrangements escaped this valuation. One of the areas which I believe that is especially hard to measure is the MTIC fraud in services, such as VoIP. This stands to prove that the losses are vaster than stated in the above studies.

\textsuperscript{67} House of Lords European Union Committee, *Stopping the Carousel: Missing Trader Fraud in the EU*
\textsuperscript{68} Europol press release, *Carbon credit fraud causes more than 5 billion Euros damage for European taxpayer*
\textsuperscript{69} Borselli, F. (2011)
\textsuperscript{70} Borselli, F. (2011)
4.3. Overview of the General Impact of MTIC Fraud

Even though it is important to analyze the numerical impact of the actual VAT lost because of fraud, there are several other effects that fraud has on the economy and that ultimately also translate in lost revenues. In the case of MTIC fraud, the seller would most likely reduce the prices for his customers, a move that would impact the competition on the domestic market and would reduce the value added of the supply chain thus increasing the overall effect on the VAT revenue.

MTIC fraud also distorts the correct calculation of the national accounts. The data on imports from the EU would not normally include the goods acquired by fraud (as the missing trader tries to cover his transaction) but the information on exports would include this data as the exporter is acting according to the law. This leads to an incorrect reflection of the imports (lower than they should actually be) and to anomalies in the intra-EU trade balance.

5. How to Detect MTIC Fraud

As mentioned, fraud can be hard to detect. Therefore, in addition to the general statistics databases (such as VIES), there is a dedicated network which aims to hinder carousel fraud. The name is EUROCANET (European Carousel Network) and it was founded by Belgium on January 1st 2005. It is normally administered by the Belgian VAT Carousel Fraud Unit (OCS). EUROCANET is an information exchange network about fiscal fraud, mainly targeting companies that are suspected of involvement in missing trader fraud. In practice it helps the tax administrations to spot VAT fraud faster due to its ample information exchange, the use of the Belgian authorities as a central coordinating point and the participation of operational administrative anti-fraud services. It exchanges monthly European sales list data and clearance requests of VAT registration numbers between participating Member States in respect of certain targeted traders. Any participating Member State can request other Member States to closely monitor a trader. Within each Member States, a maximum number of five suppliers can be under monitoring.

Germany has chosen not to participate in this information exchange and since December 2005 the UK does not want to share any information as it disagrees with the implication of OLAF (the European Anti-Fraud

71 Official Journal of the European Union (2008), C 21 E/3
72 Official Journal of the European Union (2008), C 21 E/3
73 UK Parliament website, Annex H: UK involvement in the EUROCANET project
EUROCANEIT seems to be more beneficial to the Member States whose anti-fraud systems are more rudimentary, while the UK considers that it ‘has systems in place that can identify missing and defaulting traders far more quickly than through the Eurocanet process, e.g. through pre-registration checks and, where a missing trader escapes those checks, by analysing domestic supply chains and tracing suspect deals elsewhere in the chains back to the tax loss caused by the missing trader’.  

Within EUROCANEIT, there is a by-product called AUTOCANEIT. It is also an information exchange network focused on the early detection of missing traders that activate in the car industry. The project has a preventive nature and aims to uncover fraudulent constructions and avoid wrongful VAT refunds.

In what concerns trade in emission certificates, Europol designed a special project which aims to collect and investigate data so as to put an end to the criminal organizations that support such fraud schemes. Nevertheless, experience has shown that fraudsters always reinvent themselves and find new ways to escape the legal rules. In the case of emission certificates it is believed that fraud might shortly migrate towards the gas and electricity branches of the energy sector.

It is important to keep in mind that the analysis based on the comparison of reports within each Member States might not be good enough as MTIC fraud may also involve persons that are either completely compliant or completely non-compliant with the VAT reporting requirements (e.g. an intra-EU buyer and intra-EU supplier agree on their respective conduct and thus avoid asymmetries). In addition to that, modern carousels involving non-EU countries (MTEC) cannot be detected by checks on intra-EU transactions data.

One small but hopefully important step was that the Commission proposed the amendment of the VAT Directive and the VAT Administrative Cooperation Regulation on the basis of which the Council adopted a Directive and a Regulation on 16 December 2008. This new Regulation seeks to speed up the collection and

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74 UK Parliament website, Annex H: UK involvement in the EUROCANEIT project
75 UK Parliament website, Annex H: UK involvement in the EUROCANEIT project
76 VAT circuit fraud with cars (2011)
77 Europol press release, Carbon credit fraud causes more than 5 billion Euros damage for European taxpayer
78 Europol press release, Carbon credit fraud causes more than 5 billion Euros damage for European taxpayer
79 Borselli, F. (2011)
exchange of information regarding Intra-Community transactions by shortening the period for the submission of recapitulative statements and automate the access to explicit information. An additional Council Regulation also set up EUROFISC which is ‘a mechanism provided for Member States to enhance their administrative cooperation in combating organised VAT fraud and especially carousel fraud […] and] allows for quick and targeted sharing of information between all Member States on fraudulent activities’. This mechanism focuses on specific working fields so as to combat the various types of recurring fraud. In addition to that, it details the cases when Member States must exchange information spontaneously, the procedures for providing feedback on such data and the instances in which Member States must conduct multilateral controls. All the Member States need to participate in this network which would function as an early warning mechanism but would also help its participants when acting based on the identified warnings.

6. Court Cases

6.1. Case C-409/04, The Queen, on the application of Teleos plc and Others v Commissioners of Customs & Excise

This case is not particularly carousel fraud but it shows how the traders try to outsmart the tax authorities. This case could have become part of carousel fraud as it deals with the typical products for such fraud and, as can happen in the missing trader fraud, the good were not changing location even though they were sold as Intra-Community supplies. The facts, the additional questions and the judgment are based on the published case mentioned as reference, Case C-409/04, ‘The Queen, on the application of Teleos plc and Others v Commissioners of Customs & Excise’, Judgment of the Court (Third Chamber), September 2007.

6.1.1. Facts

The case builds on an activity taken in the year 2002, when Teleos PLC, Unique Distribution Ltd, Synectiv Ltd, New Communications Ltd, Quest Trading Company Ltd, Phones International Ltd, AGM Associates Ltd, DVD Components Ltd, Fonecomp Ltd, Bulk GSM Ltd, Libratech Ltd, Rapid Marketing Services Ltd, Earthshine Ltd and Stardex (UK) Ltd sold mobile phones to a Spanish company, Total Telecom España SA/Ercosys Mobil SA (TT). These goods were supposed to be sold in France or, in some instances, in Spain and were sold based on the Incoterms EXW which meant that they were placed at TT’s disposal in

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81 European Commission presse release, Taxation: Anti-fraud network EUROFISC starts operational work
warehouse in the UK, while TT was supposed to transport them to the other relevant Member States. The warehouse was owned by Euro-Cellars Ltd., a bonded warehousing and a distribution company. A couple of days after each sale, the seller would receive from TT the stamped and signed original of the CMR consignment note which was meant to certify that the goods reached their destination by describing them, mentioning the delivery address, the name of the carrier and the vehicle registration number.

After initially accepting these CMR notes and granting Teleos and Others the right of VAT refund, the Commissioners discovered that the CMR notes were fake and that the goods had never left the territory of the UK. The Commissioners required Teleos and Others to pay the VAT due on the goods, even though they had no involvement in the fraud. TT had however declared the Intra-Community acquisition of goods to the Spanish tax authorities and the onward supply of goods as exempt Intra-Community supplies and claimed the refund of input VAT.

The national court established that Teleos and Others had no reasons to doubt the activity of their customer and no other means to establish whether the goods left the UK territory or not.

6.1.2. Additional Questions

The first two questions of the national court should be analyzed together:

- ‘The first subparagraph of Article 28a(3) and the first subparagraph of Article 28c(A)(a) of the Sixth Directive are, having regard to the term ‘dispatched’ in those two provisions, to be interpreted as meaning that the Intra-Community acquisition of goods takes place and the exemption of the intra-Community supply of goods becomes applicable only when the right to dispose of the goods as owner has been transferred to the purchaser and the supplier establishes that those goods have been dispatched or transported to another Member State and that, as a result of that dispatch or that transport, they have physically left the territory of the Member State of supply’?

First, the goods need to transfer ownership (the right to dispose of them) from the original seller to another person. The goods also need to be dispatched or transported to another Member State than the one where they were acquired, therefore out of the territory of the Member State of acquisition but still within the Community. While the first condition was fulfilled (they changed ownership title), Teleo and Others also claimed that the second was fulfilled by interpreting it as the start of the process of dispatch (goods were put
at the disposal of the buyer according to the ex-works Incoterms) but not necessarily the full physical
transport of the goods outside the supplier's Member State. Contrary to that, the National Court claimed that
the goods qualify for an Intra-Community supply when they have been dispatched and transported to another
Member State and, based on that, they have left the territory of the initial Member State.

The third question:

- ‘The first subparagraph of Article 28c(A)(a) of the Sixth Directive is to be interpreted as
precluding the competent authorities of the Member State of supply from requiring a supplier, who acted in
good faith and submitted evidence establishing, at first sight, his right to the exemption of an Intra-
Community supply of goods, subsequently to account for VAT on those goods where that evidence is found
to be false, without, however, the supplier's involvement in the tax evasion being established’?

One of the points in the generated reply was that even if the goods pass the test of the first two questions, it is
very difficult for the Member States to assess whether the goods had indeed left their territory or not.
Therefore they could only base themselves on the evidence provided by the taxable persons. Finally the
response to the question was that the first subparagraph of Article 28c(A)(a) of the Sixth Directive does not
allow the authorities of the Member State of supply to impose on a supplier, who acted in good faith and
submitted evidence establishing, at first sight, his right to the exemption of an Intra-Community supply of
goods, to account for VAT on those goods even if the evidence was discovered fake as the suppliers was not
involved in the tax evasion and he took all the reasonable measures within his power to make sure that the
Intra-Community supply that he was part of did not lead to his involvement in a fraud.

The forth question:

- ‘The fact that the purchaser made a declaration concerning Intra-Community acquisition, such as
that in question in the main proceedings, to the tax authorities in the Member State of destination can
be regarded as conclusive proof for the purposes of the exemption from VAT of an Intra-Community
supply’?

The answer to this question reflected the fact that except for establishing the Intra-Community qualifying
criteria described in the first two questions, there are no other conditions that need to be fulfilled for Intra-
Community supplies or acquisitions of goods. In short, the fact that the supplier submitted a declaration in his own country does not mean that the goods can be exempted from VAT of an Intra-Community supply.

6.1.3. The Judgment & Conclusions

The supplier cannot be held liable by the Member State to account for the VAT on the goods for which the Intra-Community supply information proved to be fake at a later time. This judgment comes as a response to the intentions of the Member States which aim to annihilate fraud but would nevertheless like to avoid convicting innocent businesses that have done all in their power to avoid fraud. However, the seller needs to make sure that his business partner is serious and the objective of preventing fraud gives a good reason for the multitude of obligations that are required when checking for seriousness.

This case is valuable when looking into the carousel fraud scheme as it builds on the principle of limited responsibility in the situation of not knowing about the fraud.

6.2. Optigen Ltd (C-354/03), Fulcrum Electronics Ltd (C-355/03) and Bond House Systems Ltd (C-484/03) v. Commissioners of Customs & Excise

This is a typical case of carousel fraud and deals with traders that are unintentionally involved in fraud. All these companies were involved in chain supplies which, without them knowing, included a defaulting trader. This defaulting trader would either be liable for paying VAT to the authorities but would disappear before submitting the money due or would hijack VAT numbers by assigning himself with VAT numbers that belonged to other companies. The facts, the additional questions and the judgment are based on the published joined cases mentioned as reference: ‘Optigen Ltd (C-354/03), Fulcrum Electronics Ltd (C-355/03) and Bond House Systems Ltd (C-484/03) v. Commissioners of Customs & Excise’, Judgment of the Court (Third Chamber), January 2006.

6.2.1. Facts

Optigen, Fulcrum and Bond House were traders buying CPUs from companies in the UK which they were afterwards selling to companies in other Member States. Optigen was denied its refundable VAT claims for June 2002 and July 2002 (amounting to over GBP 7 million for June and over GBP 13 million for July). Fulcrum was disallowed about GBP 2 million of its GBP 7.2 million VAT refund claim for June 2002 and around GBP 1.1 million of its nearly GBP 4 million Vat refund claim of July 2002. In addition to that, the
Commissioners also demanded Fulcrum to repay about GBP 160000 which was supposedly wrongfully refunded to the company for May 2002. In the case of Bond House the Commissioners first refused to pay its claim of GBP 16.3 million for May 2002 and afterwards only accepted to pay around GBP 2.7 million of that previous claim.

Initially, Optigen and Fulcrum were considered as not having received any supplies used or to be used for VAT purposes and that the amounts of VAT allegedly paid for those purchases were not input tax as the 1994 Value Added Tax Act states. In addition to that the subsequent sales were not supplies performed within a business and would not give them the right to claim a VAT refund. All in all, it was stated that their transactions were not part of an economic activity as the chain was of a fraudulent nature and does, thus, not give rise to VAT refunds.

6.2.2. Additional Questions

Even though Optigen and Fulcrum facts were somewhat different from the Bond House case, the first question was quite similar in both cases and was looking to ascertain the following:

- ‘transactions such as those at issue in the main proceedings, which are not themselves vitiated by VAT fraud, but which form part of a chain of supply in which another prior or subsequent transaction is vitiated by such fraud, without the trader engaged in the first transactions knowing or having any means of knowing, constitute supplies of goods or services effected by a taxable person acting as such and an economic activity within the meaning of Articles 2(1), 4 and 5(1) of the Sixth Directive’? and ‘in such circumstances, the right of that trader to deduct input VAT may be limited’?

The reply was that transactions that are not affected by VAT fraud do constitute supplies of goods and services despite the intention of other traders within the same chain of supply as long as they are not part of this specific transaction. In addition to that, it is assumed that the parties of the transaction that qualifies as supply of goods and services are not aware of the prior or the future fraud. As a consequence the right to deduct input VAT of the taxable persons that perform such transactions cannot be denied.

The second question:

- was meant to determine whether the answer to question 1 would violate the general principles of the Community law, e.g. proportionality, equal treatment or legal certainty.

After answering the first question, a response to the second one was considered unnecessary.
6.2.3. The Judgment & Conclusions

In light of the above, it was concluded that these companies’ right to deduct VAT should not be affected by their involvement in a carousel fraud as long as they are unaware and have no possibility of finding out about the fraud.

By using the ‘non-economic activity’ argument, the UK tried to use the idea that due to the carousel fraud, the transactions within the supply chain were not ‘economic activities’ for VAT purposes. As a consequence, any VAT paid by innocent taxable persons should not be deductible since it is not part of the VAT system and the aforementioned businesses need to take on the loss. Their argument was accepted in the VAT Tribunal but it was later rejected by the Advocate General which considered that the activities were economic activities and should be part of the VAT system. What is important to realize is that the transactions are seen as independent from the whole chain and analyzed individually by taking into account their own features. On these grounds, innocent taxable persons can escape the punishment brought upon by the fraud incurred by others. Normally, the traders are only partially able to validate that they are part of a lawful transaction and cannot demonstrate with full certainty that the goods that they are buying or that they are selling have not or, respectively, will not be part of carousel fraud. This impossibility to know for certain contradicts the legal certainty according to which the citizens should be able to organize their affairs so as to obey the law. Trying to obey this requirement in the daily business life for each transaction could become very burdensome and, in addition to that, due to the relativity of it all, the traders would not be 100% assured that their research would fully satisfy the tax administrations or the national courts.

As a future impact of this decision, the taxable persons allowed to recuperate the input VAT might also ask for interest due to the delays in proving their innocence and to having been held liable for fraud committed by somebody else. In addition to that, it is also possible that they would be asking for damage cover as their economic activity could be impacted by the delay in the refund.

Again, the Court allowed for this discharge of the trader in case but did not offer any guidance regarding the means of knowing whether traders should have known that they were involved in a fraudulent chain (either up or down the supply chain). It will therefore be very difficult for traders to foretell how the tax authorities would interpret the decision of the Court in terms of ‘means of knowing’ about the fraud involvement. It is
possible that some tax authorities would emphasize on the investigative resources on hand for the business. As a result there would be differences in between the smaller and the bigger traders which would translate into a breach of the principles of fiscal neutrality and equality of treatment. The different applications of this decision by various countries could also lead to similar transactions being treated differently in distinct Member States. As a result, companies could be motivated to search for the kindest treatment.

6.3. **Axel Kittel v Belgian State (C-439/04) and Belgian State v Recolta Recycling SPRL (C-440/04)**

This is an example of a case where the companies involved were aware of their implication in fraud and were punished accordingly. The facts, the additional questions and the judgment are based on the published joined cases mentioned as reference: ‘Axel Kittel v Belgian State (C-439/04) and Belgian State v Recolta Recycling SPRL (C-440/04)’, Judgment of the Court (Third Chamber), July 2006.

6.3.1. **Facts**

Case C-439/04: The underlying facts of this case are that the limited company Ang Computime Belgium (‘Computime’) bought and then resold computer components and within its activity it was willingly a part of a VAT carousel fraud scheme. The scheme was set up so that Computime would recover VAT invoiced by its suppliers for the same goods while the company received none of these supplies. Because of that, the authorities refused to pay Computime its refund claim for these supplies. As the company was in liquidation, Mr Kittel was at that point, Computime’s receiver.

Computime traded wholesale in computer components, which were bought from Belgium and exported to Member States, predominantly Luxembourg. From Luxembourg the parts were sent to a third party also within Luxembourg who forwarded them to the neighboring country, finally transmitting them to Computime’s supplier who never paid the VAT invoiced to Computime but did deduct it from its payable tax. On the basis of the inspection it was discovered that within a short period of time, from January 10th to June 30th 1997, Computime had traded repeatedly with the same packages of Pentium Intel CPU microprocessors and of 3290 transactions, 736 had been performed in boxes transferred over and over again, some of them as many as six times.\(^8^2\)\(^\text{Kittel and Recolta Recycling (2006), Opinion of Advocate General Ruiz-Jarabo Colomer}^\)

\(^8^2\) Kittel and Recolta Recycling (2006), *Opinion of Advocate General Ruiz-Jarabo Colomer*

\(^8^3\) Kittel and Recolta Recycling (2006), *Opinion of Advocate General Ruiz-Jarabo Colomer*
Case C-440/04: Recolta bought 16 luxury vehicles from a supplier (Mr. Ailliaud) that had previously acquired them from the company Auto-Mail. Mr. Ailliaud had no VAT to pay based on his purchases and he neither paid any VAT to the Belgian Treasury for his sale to Recolta. Recolta, in its turn, sold the vehicles with no VAT to Auto-Mail as an export sale. In reality the vehicles did not leave the Belgian territory and they were part of supply chains that were aiming at evading the tax duties. Recolta was demanded by the tax authorities to pay more than BEF 4.8 million in respect of taxes and up of BEF 9.7 million in respect of fines (approximately EUR 360 000 in total). As Recolta challenged this decision, its appeal was approved on the grounds that there was no reason to suspect that Recolta knew about its involvement in a fraud scheme and the demand for it to pay was declared null and void.

The Belgian State did not agree with this ruling and initiated appeals at higher levels, finally ending up at the Cour de Cassation.

6.3.2. Additional Questions

All the questions of the Court can be looked at together and they refer to the following:

- where a recipient of a supply of goods is a taxable person who did not and could not know that the transaction concerned was part of a fraud committed by the seller, Article 17 of the Sixth Directive must be interpreted as meaning that it precludes a rule of national law under which the fact that the contract of sale is void, by reason of a civil law provision which renders the contract incurably void as contrary to public policy on the ground that the basis of the contract is unlawful by reason of a matter which is attributable to the seller, causes that taxable person to lose his right to deduct that tax? ‘That court asks whether the answer to that question is different where the contract is incurably void for fraudulent evasion of VAT.’

- is ‘the answer to that question different where the taxable person knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT’?

As answers it was concluded that where the buyer is a taxable person who did not and had no means to know that the transaction was connected with a fraud on the side of the supplier, ‘Article 17 of the Sixth Directive

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84 Kittel and Recolta Recycling (2006), Opinion of Advocate General Ruiz-Jarabo Colomer
must be interpreted as meaning that it precludes a rule of national law under which the fact that the contract of sale is void – by reason of a civil law provision which renders that contract incurably void as contrary to public policy for unlawful basis of the contract attributable to the seller – causes that taxable person to lose the right to deduct the VAT he has paid.’ It is immaterial whether the fact that the contract is void stems from fraudulent evasion of VAT or to some different fraud.

In the opposite way, if it is proved that the supply is directed to a taxable person who knew or should have known that the transaction was part of fraud, each national court should decide whether he should not be entitled to claim back his input VAT or not.

6.3.3. The Judgment & Conclusions

This case is very useful as the decisions given in the previous cases had not been complete in what concerns repercussions for the traders considered as having been aware of their involvement in fraud.

Based on the above, the decision was that taxable persons who are unaware and cannot become aware of their involvement in carousel fraud should be allowed to reclaim VAT, while those that were aware or should have known about the fraud should lie at the national courts’ decision on whether they can reclaim the VAT or not. This, in turn, is very difficult task for the authorities as they need to clearly be able to ascertain based on objective factors what the taxable persons ought to have done in order to ensure that they are not part of fraud. The tax authorities would thus need to find out what information was available to the person in case at the time of conducting the transaction and to take only that information into consideration when assessing whether that trader should have known about his involvement in fraudulent activities.

Nevertheless, the situation is not always very clear. Even traders that are passive in the fraud (it is not their trade counterparty performing the evasion but somebody else within the chain that they are aware of) can be prosecuted. In the case of complex carousel frauds it may become quite difficult to determine which member in the supply chain had a tax evasion intention. Is it easy to discover the final trader which defaults but, due to the buffer companies, it may become less straightforward to depict any businesses up or down the supply chain that were also aware of and involved in the fraud.
The case decision does not mention specifically how the principles for cancelling the right to deduct match with the principle of neutrality. However it is for the national Courts to decide on their own whether they allow or refuse the right to deduct VAT.

6.4. ECJ, 07.12.2010 - C-285/09 ("R")

This is an example of a case when exemption for Intra-Community supplies of goods may be refused due to fraud. In this particular case, the supply of goods to another Member State did take place but the supplier concealed the identity of the purchasers so as to allow the purchasers to escape the payment of VAT for those Intra-Community transactions. The facts, the additional questions and the judgment are based on the published case mentioned as reference: ‘ECJ, 07.12.2010 - C-285/09 ("R")’, Judgment of the Court (Grand Chamber), December 2010.

6.4.1. Facts

Mr. R, of Portuguese nationality was the manager of a German company which dealt with the trade of luxury cars. His buyers were mostly car dealers established in Portugal. Starting with the year 2002, Mr. R performed several acts so as to cover up the identities of his real buyers in order to enable them to escape the due VAT payments in Portugal. As a result, his prices were more attractive and his profits were consequently higher. In practice, Mr. R would issue fake invoices to other purchasers, real businesses established in Portugal, and would use their VAT identification numbers. These businesses did indeed exist in Portugal and several knew of the fact that their names were used while others had no knowledge.

The fraud took place as the true purchasers would further sell the cars on to private buyers in Portugal and would not declare to the Portuguese tax authorities the prior Intra-Community acquisition and, thus, would not pay the VAT payable corresponding to those acquisitions. When declaring the sales, Mr. R would call them exempt Intra-Community supplies and thus register them in his annual returns as VAT-free transactions. For the German authorities these would therefore look like transactions taxable in Portugal. In case of audits, it would become intricate to discover the actual supply chains as the paper records would be misleading. For a correct tracing of the fraud, the check of the names, addresses and VAT ID numbers (which were all correct and of existing businesses) needed to be accompanied by a physical tracing of the cars. Mr. R was also good at covering his fake purchasers by naming them contractual partners in his VAT returns so as to avoid the situation in which his real buyers would be identified through VIES.
Looking into the Portuguese perspective, different sets of invoices were created. If the real (final) purchasers were known at the supply date, Mr. R would also have the vehicle registration documents issued to the purchasers at the outset. He would then generate a new fake invoice which indicated the name of the final purchaser as the recipient and the intentionally erroneous description on the invoices that taxation took place based on Paragraph 25a of the Law on Turnover Tax (UStG), which applies to second-hand vehicles. By following this scheme, Portuguese audits would be led to believe that the transactions had already been taxed in Germany.

Initially, Mr. R was sentenced to three years of prison due to tax evasion by violating his duty to collect the German VAT on his supplies, to pay it to the authorities and to declare it in his annual returns. On these grounds, he contested his sentence and a preliminary ruling by the Court of Justice was needed. The Court of Justice mentioned that each Member State needs to put together the conditions on which Intra-Community supplies are exempt so as to make sure that they are correctly and clearly applied in order to prevent evasion. It also stated that releasing fake invoices and any other activities of manipulating the evidence could work against the proper collection of VAT and could put in jeopardy the VAT system.

6.4.2. Additional Questions

The German Bundesgerichtshof thought necessary to address a question for preliminary ruling as Mr. R could avoid criminal prosecution if his transactions were deemed Intra-Community supplies covered by the first subparagraph of Article 28c(A)(a) of the Sixth Directive. As a result, his implication in tax evasion in Portugal could not be a criminal offence under the German fiscal criminal law.

The German Bundesgerichtshof asked the following question to the Court of Justice for a preliminary ruling:

- ‘Must Article 28c(A)(a) of the Sixth Directive be interpreted as meaning that a supply of goods within the meaning of that provision is to be refused exemption from value added tax if the supply has actually been effected, but it is established on the basis of objective factors that the vendor, a taxable person,

(a) knew that, by his supply, he was participating in a transaction aimed at evading VAT, or
(b) took actions aimed at concealing the true identity of the person to whom the goods were supplied in order to enable the latter person or a third person to evade VAT?’

Mr. R tried to cancel this request for a preliminary ruling but his act was rejected and the request was accepted as the national court had provided the Court of Justice with factual and legal material that was correct in the light of these facts.

The answer to the question was that whenever Intra-Community supplies of goods have actually taken place but, the seller of those goods tried to hide the identity of his real buyers so as to allow them to avoid paying VAT, the Member State of departure of the Intra-Community supply may decline to allow an exemption corresponding to that transaction.

6.4.3. The Judgment & Conclusions
Case R is an extension of the Kittel case where instead of criteria for refusing the right to deduct input credits, R sets out criteria for declining the exemption on Intra-Community supplies. In other words, as the Kittel judgment asks for the refusal of the right to deduct VAT when the person knew or should have known that he was involved in a transaction related to evasion of VAT, the R judgment asks for the refusal of the Intra-Community exemption for the supplier of goods and for this supplier to pay the arising tax duty if there are true reasons to suppose that his sale would escape the payment of VAT in the destination Member State.

If the right to exemption is denied on such grounds, there is no breach of the principles of fiscal neutrality, legal certainty, or protection of legitimate expectations since the trader involved has knowingly participated in a scheme which might disturb the whole VAT system.

6.5. The Commissioners of Customs and Excise, Attorney General v Federation of Technological Industries and Others, Case C-384/04 of 11 May 2006 (“FTI”)
This case is exemplary for the participation in carousel fraud which results in a judgment involving the joint and several liability in the case of UK. The facts, the additional questions and the judgment are based on the published case mentioned as reference: Case C-304/04, ‘The Commissioners of Customs and Excise, Attorney General v Federation of Technological Industries and Others’, Judgment of the Court (Third Chamber), May 2006.
6.5.1. Facts

The case builds on two measures introduced in the Finance Act 2003 which were meant to fight the missing trader type of fraud and were concerning only the traders in telephones and computers (plus their related parts and accessories). One of these measures, explained in the Act’s Section 17 refers to a ‘requirement of evidence or security’. By this requirement, the trader can be demanded to show security for the payment of any VAT due on the supply of relevant goods or services. Based on the trader’s challenge of the demand to provide security, the Commissioners need to demonstrate that the trader was trying to engage in evasion with those goods or services.85

The second measure, described in Section 18, aims to make one trader jointly and severally liable with another business in case of a relevant supply for which the taxable person knew or had reasons to assume that VAT would not be paid on it. The Commissioners would notify the taxable person and if he / she appeals then the Commissioners would need to prove to the Tribunal that the trader either knew or had reasonable grounds to know that the VAT on the respective transaction would not be paid.86

FTI was the trade body of 53 traders in mobile phones and computer processing units (CPUs). Together, they decided to challenge the two provisions of the Finance Act that were described above. They asked for a judicial review of the provisions as they considered that they were not authorized by Community law.

6.5.2. Additional Questions

The five questions that were addressed were the following:

- ‘Does Article 21(3) of [Sixth Directive 77/388], as amended by [Directive 2000/65], permit Member States to provide that any person may be made jointly and severally liable for payment of tax with any person who is made so liable by Article 21(1) or 21(2), subject only to the general principles of Community law, namely that such a measure must be objectively justifiable, rational, proportionate and legally certain?

- Does Article 22(8) of [Sixth] Directive [77/388, as amended.] permit Member States to provide that any person may be made so liable or to provide that one person may be required to provide security for tax due from another subject only to the aforesaid general principles?

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85 Finance Act (2003)
86 Finance Act (2003)
• If the answer to the first question is no, what limits, other than those imposed by the aforesaid general principles, are there on the power conferred by Article 21(3)?
• If the answer to the second question is no, what limits, other than those imposed by the aforesaid general principles, are there on the power conferred by Article 22(8)?
• Are Member States precluded by [Sixth] Directive [77/388], as amended, from providing for joint and several liability of taxpayers or from requiring one taxpayer to provide security for tax due from another in order to prevent abuse of the VAT system and protect revenues properly due under that system, if such measures comply with the aforesaid general principles?’

The first and the third question were relevant to considered together. The answer to them was that if a trader is aware that he is involved in a fraudulent transaction which would result in the nonpayment of VAT then he may be made jointly and severally liable with the main person that is responsible for the fraud and needs to account for the payment of that VAT. Nevertheless, for question three, this regulation would have to comply with the principles of legal certainty and proportionality.

The second and fourth questions were also considered relevant to be analyzed together. The answer for them was that the Member States would not be allowed to pass legislation that taxable persons who are aware of their involvement in a VAT fraud should be made liable together with the guilty person for the payment of the VAT, neither legislation which requires a trader to provide security for paying VAT which is or could become payable by the taxable person to whom he supplies those goods or services or who supplies these goods or services to him. Nevertheless ‘that provision does not preclude a national measure which imposes on any person who is, pursuant to a national measure adopted on the basis of Article 21(3) of the Sixth Directive, jointly and severally liable for payment of VAT, a requirement to provide security for the payment of the VAT due’. 87

Finally, the fifth question was considered unnecessary to respond based on the replies given for the first four questions.

87 Case C-304/04
6.5.3. The Judgment & Conclusions

FTI tried to challenge the validity of the ‘joint and several liability’, a provision that can be imposed on traders dealing with mobile phones and computer supplies as these products are very prone to missing trader fraud and, more specifically, carousel fraud. Even though FTI was of the opinion that there is no general power able to derogate from the general regulation that only the persons performing the transactions should be liable for VAT payment, the Court decided that other traders can be made jointly and severally liable for the VAT payment. However, it is important to keep in mind that, in doing so, the Member States need to respect the general principles of decisions being objectively justifiable, rational, proportionate and legally certain.

In the words of the Court ‘Traders who take every precaution which could reasonably be required of them to ensure that their transactions do not form part of a chain which includes a transaction vitiated by VAT fraud must be able to rely on the legality of those transactions without the risk of being made jointly and severally liable to pay the VAT due from another taxable person’. 88

With this in mind, any taxable persons that take on the trade in telephones or computers (plus accessories) should do everything in their power to ensure that they are not part of a missing trader fraud. If it is discovered that the supply chain is fraudulent, they would not be held jointly and severally liable as long as they had no awareness of their implication in such fraud.

6.6. Dragon Futures Ltd v HMRC89

In order to show how one case builds on another and together they form the framework of, in our case, deciding about the right to deduct VAT in case of missing trader fraud, the case of Dragon Futures Ltd. V HMRC will be taken into consideration.

88 Case C-304/04
89 UKVAT V19831, Dragon Futures Ltd v Revenue & Customs
6.6.1. Facts

The case was an ongoing litigation with regard to HMRC’s unwillingness to refund the VAT on input tax for the trade of mobile phones and other electronic equipment to other Member States as this trade was considered part of MTIC fraud chain.

6.6.2. Conclusion, Connection to Previous Cases and Learning Points

Based on this case the main conclusion was related to the ‘knowledge test’ and the ‘means of knowledge’ that the trade was part of fraud. The judgment for the case is built based on the decisions made for the Optigen Ltd (C-354/03), Fulcrum Electronics Ltd (C-355/03) and Bond House Systems Ltd (C-484/03) v. Commissioners of Customs & Excise, the Axel Kittel v Belgian State (C-439/04) and Belgian State v Recolta Recycling SPRL (C-440/04) and the Commissioners of Customs and Excise, Attorney General v Federation of Technological Industries and Others, Case C-384/04 of 11 May 2006 ("FTI") cases.

Specifically, the case addressed the following points:\(^{90}\):

- which is the legal test that must be satisfied by both parties mostly with respect to: the expression ‘of which that taxable person had … no means of knowledge' ('Bond House' judgment paragraphs 51, 53, 57) and 'without that taxable person having any means of knowing' ('Bond House' judgment, paragraphs 52, 55, 57) and is the test objective or subjective?

The approach should be objective and, in short, the trader needs to be evaluated both by the level of actual knowledge and the actions taken, or not taken, to acquire knowledge at the time of entry into the commitment for which he is claiming the VAT refund, all respecting the principle of proportionality. The principle of proportionality states that ‘a public authority may not impose obligations on a citizen except to the extent to which they are strictly necessary in the public interest to attain the purpose of the measure’.\(^{91}\) In addition to that, one cannot make use of hindsight which means that the time that should be investigated is the time at which the taxable person entered into the transaction. In addition to that, the trader needs to respond to the information indicating the fraud and this information should not only be restricted to the counterparty of the transaction but to the whole market of the good in case, or other known specific

\(^{90}\) UKVAT V19831, Dragon Futures Ltd v Revenue & Customs

\(^{91}\) Detention in Europe website, Principle of proportionality
fraudsters. The trader also needs to strive to increase his actual knowledge about the prospective fraud. He could achieve this by checking the validity of the VAT registration numbers, customs stamps, checks with and about individual suppliers and customers, checks with national registration institutions, with credit agencies and inspection agencies, including checks on the IMEI numbers of telephones; use of appropriate terms of contract. Nevertheless, the case stipulates that ‘a taxable person cannot be expected to take steps to ensure a transaction is clear of fraud beyond all reasonable doubt’.  

6.7. General Conclusions

I believe that the cases detailed above are very valuable in the context of fighting against the missing trader fraud as they are used as reference points for subsequent judgments of new cases. In major lines, it seems to be quite difficult to ascertain whether specific traders involved in missing trader fraud have been aware of their wrongdoings or have fallen prey to intricate fraudulent arrangements that took advantage of their good faith. It can be noticed that, naturally, the Courts are trying to provide judgments that are fair to all of the members involved, even though it sometimes is unclear where the guilt lies.

On these grounds, I consider that the main points of attention are the following. First of all, the supplier cannot be held liable by the Member State to account for the VAT on the goods for which the Intra-Community supply information was proved false at a later time. Nevertheless, the seller has the duty to ensure that his business partner is trustworthy and to perform certain checks when entering into business with him. In my opinion, even though this is not an exact case of missing trader fraud, this judgment contributes to the concept of limited responsibility in the situation of fraud unawareness.

Secondly, trades who are unaware of fraud and have no possibility of finding out about the fraud should not be refused the right to deduct VAT. In other words, guiltless traders can avoid being punished for the fraud set up by other parties. However, the question that remains is related to the means of knowing that one is involved in a fraudulent chain as there are no clear, given ways of ensuring and proving the lack of awareness.

Thirdly, I believe that it is also important to look at how economic agents that have been judged as knowledgeable of their implication in fraud will be disciplined. Based on the analyzed case, it is the national courts that need to decide whether the traders can claim VAT or not. An essential point is that even traders

92 UKVAT V19831, Dragon Futures Ltd v Revenue & Customs
that are not directly involved in fraud (they are not one of the fraud traders but are aware of fraud within their chain) can be put on trial. In the case of complex setups, proving fraud awareness or lack of it can become a very subjective activity.

Fourthly, the Intra-Community exemption for the supplier of goods can be refused and he can be demanded to pay the relevant tax duty if there are accurate reasons to presume that his sale would escape the payment of VAT in the destination Member State.

Fifthly, through the ‘joint and several liability’ concept, not only the persons performing the fraudulent transactions should be liable for the VAT payment but also traders can be made jointly and severally liable for this penalty. Nevertheless, the Court aimed to protect the honest traders and claimed that they should not be liable to fines as long as they take every precaution that could be reasonable required of them to make sure that they don’t get involved in a fraudulent chain of transactions.

Finally, ‘the knowledge test’ builds on a set of cases and concludes that the business agent’s culpability needs to be evaluated both by the level of actual knowledge and the actions taken, or not taken, to acquire knowledge at the time of entry into the commitment. This should be done through the principle of proportionality and should not take into account hindsight but the time when the trader entered into the transaction.

7. Can MTIC Fraud be Avoided – General Measures

The EU is constantly trying to come up with solutions so as to end MTIC fraud, and implicitly, carousel fraud. Nevertheless fraud is constantly changing following ‘the principle of running water’\(^{93}\). According to this principle, frauds adapt to the changes in the environment, legislation and auditing targets. As approaches, the EU has worked within the lines of increased administrative cooperation in between the Member States, novel compliance requirements and special rules for sectors that have been identified as high risk and are prone to fraud. Some of the ideas to combat fraud have actually required a quite drastic transformation of the VAT system. Some noteworthy suggestions will be discussed in this chapter.

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\(^{93}\) Mogensen, et. al. (1995)
7.1. Taxation of Intra-Community Supplies in the Member State of Departure (The Origin Principle)

Each Member State wishes to be in control of the VAT rates applicable within its territory. Therefore, in order to maintain this liberty but also to avoid fraud during Intra-Community trade, the suggested change would be to replace the zero rated supplies with a taxation rate of 15%. In practice this would mean that in the case of national VAT rates higher than 15%, the additional VAT will build up to that state and in case of lower national VAT rates, that state would grant a credit to the trader performing the Intra-Community acquisition.\textsuperscript{94}

The Commission’s response to this suggestion mentioned that this approach would probably avoid MTIC fraud but would not solve other types of fraud. In reality, it would possibly increase the risk of other existing types of fraud to be applied to these transactions. The issue of competition was also taken into account as there would be potential cash flow impacts. Unable to detail this impacts without a more indepth analysis, the Commission was however of the opinion that SMEs would likely be further disadvantaged (as pre-financing is already a problem for them).\textsuperscript{95} Looking into additional aspects, this principle would also probably determine certain firms to relocate to lower VAT Member States as this would generate a lower VAT burden.

In terms of the clearing system, the proposition referred to the use of recapitulative statements. Each taxable person that is performing Intra-Community supplies needs to report in each quarter the total supplies to each taxable person in another Member State on a recapitulative statement which will be submitted to the tax administration of the taxable person who makes the supply.\textsuperscript{96} This would translate into costs for the taxpayers. The necessary recapitulative statements would become monthly and the costs would be of a one off nature (due to the first setup of the change) and minor going forward. All the Member States would be affected by this clearing system and they would at the same time have to pay and receive money from the other states. According to the statistics, the value of the Intra-Community supplies in the total supplies for

\textsuperscript{94} COM(2008) 109 final
\textsuperscript{95} COM(2008) 109 final
\textsuperscript{96} DG TAXUD webpage, VIES FAQ
the states is of 10 and 20%. Because of this, the Member States could still rely on the VAT collected through the domestic transactions which should consequently amount to 80 to 90%.

A consequence of this clearing system would be that Member States would become liable to pay VAT to their counterparts even though they had not yet collected the VAT due by their taxpayers. They would also have to control for the over deduction of VAT.

The Commission’s conclusion was that it needed more guidance from the Council in order to see whether this approach would be viable and should be considered. In practice, this method would become more viable if the Member States narrowed the differences in between the VAT rates that they apply within their territories.

7.2. Introduction to the Reverse Charge Mechanism

By applying this principle, the responsibility of accounting for the VAT on the supply shifts from the seller to the purchaser. The supplier thus does not charge VAT but needs to specify on the invoice that the reverse charge is applicable. The purchaser has the right to input tax recovery within the same VAT return. If the recipient sells the goods or services again then he will charge the VAT from the buyer and will need to pay it (domestic transactions).

Following Article 395 of the VAT Directive, Member States may be authorized to follow their own measures so as to ease the procedure of collecting VAT or to prevent tax evasion. The Member State in case would need to apply to the Commission in order to benefit from this derogation. The Commission would afterwards either present a proposal to the Council or present a Communication with its objections. This is the process that any Member State would have to go through should they want to introduce the reverse charge for other supplies than those already existing in the legislation.

97 COM(2008) 109 final
98 COM(2008) 109 final
99 HMRC website, VATF44200 - Basic interventions: Other interventions: Reverse charge on specified goods and services
At this point the reverse charge applies to goods or services where the supplier is not established in a Member State. This simplifies the collection of VAT due to the difficulty of tracing traders that are not established in that country. Member States have the choice to introduce the reverse charge in sectors or transactions that have been identified as susceptible to tax evasion.\textsuperscript{101}

The Commission has launched several Communications with the scope of eradicating VAT fraud. In May 2006 it published a Communication which was meant to launch a debate at the EU level for a harmonized approach to the Internal Market fiscal fraud, ‘Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee concerning the need to develop a co-ordinated strategy to improve the fight against fiscal fraud’. In November 2007, the Commission published a new communication meant to put in place an anti-fraud strategy, ‘Communication from the Commission to the Council concerning some key elements contributing to the establishment of the VAT anti-fraud strategy within the EU’. Still in November 2007 the Commission also published the state of play ‘Report on the state of play of the discussions on the conventional measures to combat VAT fraud proposed by Member States’. All these led in 2008 to a ‘Communication from the Commission to the Council and the European Parliament on measures to change the VAT system to fight fraud’.

Within the latest Communication above, the Commission replies to two previous requests of the ECOFIN Council which involved the examination of two anti-fraud methods: ‘the taxation of Intra-Community transactions and the introduction of the option of applying a blanket reversal of tax liability (a general reverse-charge system)’.\textsuperscript{102} Besides, the Commission had also been requested to look into the option of implementing a limited time reverse-charge pilot project in a voluntary Member State.

Reverse charge would be very useful for eliminating the cross-border fraud as the businesses would not be collecting any VAT during their business-to-business trade. However, this mechanism would generate a higher incentive for fraud at the retail level. Based on a study evaluating the experience with US sales tax “a single point retail sales tax is efficient at relatively low rates, but is increasingly difficult to administer as rates rise”\textsuperscript{103}. “At 5%, the incentive to evade tax is probably not worth the penalties of prosecution; at 10%,

\begin{footnotes}
\item[102] COM(2008) 109 final \\
\item[103] Tait, A. A. (1988) \\
\end{footnotes}
evasion is more attractive, and at 15-20 percent becomes extremely attractive”.\textsuperscript{104} Looking into the current VAT rates within the EU, considering that most of them are over 20\%, one would clearly see how this could become an incentive for fraud.

7.3. Generalized Reverse Charge in Practice

The proposed generalized reverse charge mechanism would only apply to business-to-business supplies over an individual transaction threshold of EUR 5,000. In order to be able to apply this procedure, each taxable person should check the status of its customer for all the individual domestic transactions. For the customers not qualifying for the reverse charge, the supplier would have to charge them VAT.\textsuperscript{105} For the customers that do qualify but perform transactions below EUR 5,000, the supplier would again have to charge them VAT. Finally, only for the remaining customers that are over the threshold, the supplier would not charge VAT and the customer becomes liable to pay VAT (which of course can be deducted according to his balance of VAT and transactions).

Based on a study ordered by the Commission to a consultant, several risks related to the generalized reverse charge were identified. These findings were based on workshops and discussions with VAT experts as there was no real life data for this mechanism.\textsuperscript{106}

The main findings of the study were that by introducing the generalized reverse charge\textsuperscript{107}:

- Fraud would converge towards the retail level as it would be the base for VAT collection. The likely loss of VAT revenue could be higher than within the current system as the authorities would find it more difficult to audit all the economic operators (which might be many and of differing sizes).
- There would be an increased hijack of VAT identification numbers (so as to evade paying VAT or to introduce goods on the black market).
- Abuse by pure holdings on their own.
- Shift of missing trader fraud to Member States that had not implemented the reverse charge and also use a big VAT rate.
- Fake invoices to lower a (high) payment position.

\textsuperscript{104} Tait, A. A. (1988)
\textsuperscript{105} SEC(2008) 249
\textsuperscript{106} SEC(2008) 249
\textsuperscript{107} SEC(2008) 249
• MTIC imitation in the domestic area.
• Better access of goods to national (and cross-border) black markets and at more attractive prices.

The study also suggested several methods of avoiding the application of the reverse charge and sustaining fraud. These refer to the direct or hidden artificial division of the taxable amount of transactions so as to dodge the threshold and the migration of the artificial splitting to Member States that use a high VAT rate and implemented the reverse charge. These methods would help fraud by allowing businesses to buy products VAT free and to charge VAT on their sales as the amounts would be under the set threshold. Finally they would disappear and would not pay VAT to the tax authorities.

There have also been identified several methods of avoiding the VAT fraud and these consist of:
• Implementing a compulsory reverse charge mechanism in all the Member States;
• No threshold for the invoices, and if there is the necessity of one, then it should be lower than EUR 5,000;
• Monthly sales and purchase listings all the domestic transactions (not only those falling into the reverse charge) in order to spot the artificial splitting;
• Special identification for taxable persons that are eligible for purchases with the reverse charge;
• New data-mining tools and risk indicators;
• Enhance the registration rules;
• Enhance the exchange of information among the Member States;
• Computerised taxable person identity cards that would confirm that the taxable person is a legitimate trader.

Even though the study suggested the reduction of the threshold, the Commission considers this a potential trigger of undesirable effects and would like to keep it as was initially suggested. Setting the threshold lower might generate fraud based on acquiring goods free of VAT. Setting the threshold higher might result in deduction related fraud, MTIC fraud at a domestic level.\textsuperscript{108}

\textsuperscript{108} SEC(2008) 249
Based on the study the Commission concluded that it did not have enough information to properly assess the viability of this approach. The scale of the MTIC fraud would indeed be reduced as the value of invoices would be spread over many invoices under the set threshold. Nevertheless, there is a big possibility that the goods would be directed towards the black market which would in turn lead to higher revenue losses than those happening under the current VAT deduction scheme.

This solution would considerably diminish the MTIC fraud and other sorts of deduction fraud but would give rise to other types of fraud which would end up negatively affecting the revenues of the Member States.\textsuperscript{109}

In order to apply this method, the system would need several amendments which would make it more complicated. These are the following\textsuperscript{110}:

- **Threshold to be applied**: The purpose of this measure would be to limit the risk on untaxed final consumption. It would trigger distinctions that are not currently in place and do not reflect the commercial reality and also sets of definitions that would render it feasible and would cover all the potential scenarios.

- **New responsibilities for taxable persons that would be allowed to make purchases with the reverse-charge system**: the system would differentiate taxable people that would be able to operate such purchases and those that won’t. Consequently those that qualify for it would need to obey new responsibilities. The tax administrations would be the ones who need to formulate the required tools for the persons to decide whether they operate under the reverse charge or not. It is also likely that the taxable persons would use both systems in parallel, fact that would increase the level of complexity. In addition to that it is also possible that there will be an increase in the amount of refund claims as certain taxable persons would not be able to offset input tax on minor acquisitions as their output would remain untaxed under reverse charge. Finally there would also be an increase in the human resources needed to monitor the correct functioning of the system.

- **Compensatory reporting obligations**: they would counteract the annulment of fractioned payments and would help with the comparison of the data received from the suppliers and the acquirers.

\textsuperscript{109} COM(2008) 109 final
\textsuperscript{110} COM(2008) 109 final
Among the defects of such an approach one can also add the fact that it would impinge on the harmonization of the EU VAT system. Operating under a dual system of taxation would increase the burden on future legislation. The Commission’s conclusion was that the system should either be introduced on a compulsory basis or should be disregarded as a concept.\footnote{COM(2008) 109 final}

The Commission also offered to run a pilot project in order to test the feasibility of the reverse charge (as no Member State had used such a system and there was thus no other way to properly assess the viability of such an approach). The reverse charge would only be tested under its ‘mandatory’ function as opposed to the ‘optional’ category. The results of such a test would help understand the actual success of the approach (reduce VAT gap and other types of fraud), other arising types of fraud and their countermeasures, costs of implementing it versus the benefits.\footnote{COM(2008) 109 final}

The Commission also estimated the timing of the project to 5 years, while the results could be assessed only after three years once the project ends.

7.4. Targeted Reverse Charge

In addition to the general measures, several Member States have requested through a Derogation of the Council by means of Article 395 of the VAT Directive to fight against VAT fraud through a targeted reverse charge system for particular fraud sensitive sectors or certain goods.\footnote{COM(2009) 511 final} The interested Member States would apply this targeted reverse charge mechanism by making a choice from a predefined list of goods and services that had been identified as susceptible to fraud.

The items for which the targeted reverse charge would be applicable consist of: greenhouse emission allowances, mobile phones and integrated circuit devices (the UK had been granted a reverse charge derogation for these items), other products (e.g. perfume, precious metals) that have been identified by the Member States as goods which have attracted fraud.\footnote{COM(2009) 511 final}
In practice this reverse charge system would mean that no VAT is charged by the supplier to taxable customers and that these taxable customers would become liable to pay VAT to the tax authorities. The customers, if they are normal taxable persons and have the full right of deduction, would both declare and deduct the VAT at the same time without having to pay anything. Thus, the possibility for fraud would be diminished.

If they would like to follow this mechanism, Member States should initially inform the Commission about their interest in introducing this. The application of the method would also entail specific conditions that would back up the scheme. Before the application of the scheme the taxable persons that will fall in the scheme need to be identified for VAT purposes under an individual VAT number. The Member State would also have to create reporting obligations so as to make sure that the measure is properly monitored. Finally, any Member State can only apply the targeted reverse charge to a maximum of three categories among which two can be goods.

In March 2010 the Council released a Directive which allowed the application of the targeted reverse charge to greenhouse emission allowances. The Directive requested the Member States introducing this approach to release an evaluation report in order to measure its efficiency. The reports are to be based on predefined criteria set by the Member States and should look into the following items:\footnote{Council Directive 2010/23/EU}:

- Level of fraud before and after the use of this mechanism;
- Shifts in trends of fraud activities;
- Compliance costs for taxable persons.

The Directive covers the period of release (20 days after the publication in the Official Journal of the European Union on 20 March 2010) to 30 June 2015 and enables the Member States to introduce this change for a period of minimum 2 years. Any Member State that had detected a shift in trends of fraudulent activities needs to submit a report to the Commission by 30 June 2014.\footnote{Council Directive 2010/23/EU}
In short, in comparison to the original VAT scheme, the steps within a reverse charge mechanism would be the following:

Reverse charge helps stop the MTIC fraud at all the stages of the supply chain except for the retail level where the potential for fraud is still existent and quite big.¹¹⁷ The burden for the businesses is increased as they need to continuously make sure that their VAT free customers will indeed be using the products for business purposes.

In 2006, the UK requested the right to apply the reverse charge for products such as mobile phones, handheld communication devices, games consoles and computer chips for an invoice value of at least £1,000. The Commission accepted this request but only for a limited time of application (until end of 2009) as it did not create a very high burden on the taxable persons and also only 22,500 businesses out of a total of 1.9 million VAT-registered businesses in the UK were identified as being affected by it.¹¹⁸ After that, the UK requested to extend this anti fraud measure and was allowed to continue as such until 30 April 2011. However the

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minimum amount of an invoice was of £5,000. Afterwards, the UK was granted an additional extension until 31 December 2014.

Austria and Germany also requested the implementation of this mechanism for all the business-to-business transactions with a minimum invoice value of EUR 10,000 for Austria and EUR 5,000 for Germany. Austria’s estimates of the affected invoices by applying this mechanism would amount to about 7 million invoices issues in Austria. Germany approximated the impact to the 0.5% of all the invoices issued in Germany, in other words 130 million invoices. Their requests were rejected due to the fact that they were too broad and they would unreasonably augment the compliance costs for businesses plus boosting the chances for VAT fraud at the final consumption level. In addition to that, they would affect sectors that had never been affected by VAT fraud and would disrupt the internal market as businesses would encounter differing rules and procedures applicable in different Member States.

It is very important to note that the implementation of the reverse charge mechanism would not reduce the unregistered sales (‘black sales’). In fact, the incentive to get black supplies would be boosted as taxable persons who would have to charge VAT at the end of the sale would have to account for the full VAT amount and not only for the fractioned part as they used to do during the previous process.

Through the reverse charge mechanism, the financial risk of the VAT payments would be shifted from the Member States to businesses as the latter ones would become in charge of deciding whether or not they should charge VAT (based on the regulations of each Member State) and whether or not the customer falls into the application area of the reverse charge (authentic taxable person or not). This transfer of liability would go against the Lisbon objectives.

‘Zero-rating an intermediate supply temporarily breaks the chain of fractionated payments’. And this goes against the whole principle of VAT as a fractionated tax. If it is applied to a single product then indeed it

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119 COM(2009) 183 final
120 2010/710/EU
121 COM(2006) 404 final
122 COM(2006) 404 final
123 COM(2006) 404 final
124 Ainsworth, R.T. (2010a)
would help avoid the MTIC fraud. However if this starts to be applied broadly then it will transform into a retail sales tax.\textsuperscript{125}

7.5. Joint and Several Liability

‘In the situations referred to in Articles 193 to 200 and Articles 202, 203 and 204, Member States may provide that a person other than the person liable for payment of VAT is to be held jointly and severally liable for payment of VAT’.\textsuperscript{126} Thus, another anti fraud measure would be to allow Member States to hold accountable another member than the one liable to pay the VAT due. This is an optional measure and has been applied in different manners by the Member States and was also highlighted in one of the above described cases, The Commissioners of Customs and Excise, Attorney General v Federation of Technological Industries and Others.

This measure would be beneficial in the case of MTIC fraud as it brings together several players which are trying to hide this illegality and to complicate the exposure of the fraud. Nonetheless, it is important to make sure that there is a clear equilibrium between the legal certainty of authentic businesses and improving the ability of the tax authorities to recuperate the big amounts of uncollected VAT due to fraud.\textsuperscript{127} It is vital to ensure that the rules clearly identify people that knew about their involvement in fraud from the honest, innocent traders that become involved without their knowledge and intent. If the latter ones receive a punishment then the mechanism would create more issues than the ones that it is solving. As an example, in the UK, ‘a person shall be presumed to have reasonable grounds for suspecting matters to […] if the price payable by him for the goods in question (a) was less than the lowest price that might reasonably be expected to be payable for them on the open market, or (b) was less than the price payable on any previous supply of those goods.’\textsuperscript{128} These grounds for liability of involvement in fraud can hamper trading. According to these rules, any taxable person who is enjoying reduced rates of certain products can become guilty of fraud, fact that somehow works against the whole business process.

\textsuperscript{125} Ainsworth, R.T. (2010a)
\textsuperscript{126} Council Directive 2006/112/EC
\textsuperscript{127} COM(2007) 758 final
\textsuperscript{128} UK Value Added Tax Act (1994)
The Commission also suggested that the person not complying with reporting obligation on the cross border transactions could also be held jointly and severally liable for the tax revenue losses of the tax authorities.\textsuperscript{129} Under this guideline it is assumed that by not complying with the reporting, these persons are hindering the Member State’s capacity to detect fraud and to take measures against it. The Commission was hoping to enhance the quality of the reporting and to complicate the creation of fraud schemes. In a proposal to the Council, the Commission suggested that the persons that did not submit recapitulative statements containing the information concerning the supply, or the recapitulative statements submitted by them did not set out the information concerning the supply as mentioned within Article 264, will be held jointly and severally liable for the payment of the VAT that was due on the Intra-Community acquisition of those goods that should have been declared.\textsuperscript{130} There were nevertheless two exceptions, as follows\textsuperscript{131}:

‘However, the first subparagraph shall not apply in the following situations:

(a) the customer has, for the period during which the tax became chargeable on the transaction concerned, submitted a VAT return as provided for in Article 250 containing all the information on this transaction;

(b) the person supplying goods in accordance with the conditions laid down in Article 138 can duly justify to the satisfaction of the competent authorities his shortcoming referred to in the first subparagraph of this paragraph.’

Under this method it becomes possible for taxable persons that fail to submit correct reports to become liable for frauds that they had not been involved in. The intentions of the Commission are fair but the application of this proposition could lead to undesired results as it assumes that all the persons that did not submit correct returns are trying to commit fraud. The Council agreed with part of the Commission’s proposal, leaving the amendment regarding the joint and several liability for another discussion by mentioning that it would continue to work on it.\textsuperscript{132}

\textsuperscript{129} COM(2008) 807 final
\textsuperscript{130} COM(2008) 805 final
\textsuperscript{131} COM(2008) 805 final
\textsuperscript{132} 10430/09
7.6. The Knowledge Test

Together with the resolution for two ECJ cases (C-439/04 and C-440/04), the ECJ also brought to light the knowledge test. This test links the right to deduct VAT of certain taxable persons with the obligation to pay VAT of others based on the first ones’ knowledge of the VAT fraud related to that chain of transactions. By doing so, the ECJ brings a new burden for the traders as they need to take on new responsibilities. In practice, ‘if the tax administration can prove that the customer knew or should have known that he was participating in a transaction linked to VAT evasion, the tax administration can refuse the right to deduct to that taxable person’. Nevertheless, if the taxable persons do take all the reasonable measures to enquire about the transactions and to ensure that they are not part of fraud, then they should still be allowed to collect the input VAT. It can become very burdensome for the traders to certify for each of their transactions that they are not part of a fraudulent chain. But it would also prove very costly and resource intensive for the tax administrations to demonstrate that the traders knew or should have known that they were involved in transactions that related to fraud.

What is also important to keep in mind for the knowledge test is that there is a long time (even several years) during which a taxable person can be held indirectly liable for a fraud committed by somebody else. In order to avoid this situation, the traders need to take ‘every precaution which could reasonably be required of them to ensure that their transactions are not connected with fraud, be it the fraudulent evasion of VAT or other fraud’.

Since the decision whether the traders took reasonable measures to ensure that they are not part of fraud lies with the courts of each Member State, it is very possible that it would lead to dissimilar results. On this account, a taxable person could be treated differently according to the Member State that rules the decision. As a consequence, even within the same fraudulent supply chain, the traders would have different rulings.

It is also interesting to look into the possible differentiation of the taxable persons according to their VAT knowledge. Looking at the EJC Cases C-64/89 Deutshe Fernsprecher GmbH and Case C-48/98 Fima Sohl & Söhlke, one can see that the ECJ considers it relevant to look into more details relating to the level of

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133 SEC(2010) 1455 final
134 SEC(2010) 1455 final
135 Joined Cases: Axel Kittel v Belgian State (C-439/04) and Belgian State v Recolta Recycling SPRL (C-440/04)
knowledge of the traders. Even though these cases are not on the topic of carousel fraud, the following conclusions can also be applied when trying to assess the fraud awareness of the taxable persons involved in a ‘missing trade’ type of fraud. It is important to establish whether a fairly inexperienced trader could be evaluated in the same manner as an experienced, very VAT knowledgeable taxable person. First of all ‘account must be taken in particular of the precise nature of the error, the professional experience of, and the care taken by, the trader’.\textsuperscript{136} In addition to that, ‘in order to determine whether or not there is 'obvious negligence' […] account must be taken in particular of the complexity of the provisions noncompliance […] and the professional experience of, and the care taken by, the trader’.\textsuperscript{137} In other words professional experience can be a component when evaluating whether there is the case ‘obvious negligence’ or not.

8. Can MTIC Fraud be Avoided – Innovative / Alternative Measures

8.1. Digital Systems

8.1.1. General Approach

In addition to all the methods suggested above there is another set of solutions that might be able to help reduce fraud. The VAT collection system has been practically unchanged since its introduction, virtually ignoring the rapidly evolving technological environment which could help introduce new and alternative methods of collecting VAT and of reducing the administrative burdens that companies currently face. The VAT collection process still depends in major lines on the self-assessment of the trader which is later on followed by audits from the tax administrations. Based on the rapid and intense technological developments, the society could make a better use of such systems and shift from tracking VAT through paper invoices. These paper invoices make it difficult to follow a VAT audit trail and to pick out the incompliant traders. There are also considerable delays from the moment customers pay VAT to the moment the sellers pay it back to the authorities and that enables some traders to evade before having to pay their VAT duties to the authorities. As an example, a transaction in tradable services can be finished in a couple of minutes and the VAT fraud can take place in the following next minutes. As reporting might be only due in a couple of months, that stolen VAT can travel through multiple banks and countries and then have its trace lost by a withdrawal in a remote country. At the same time, the tradable service has been consumed and, consequently, has vanished.

\textsuperscript{136} Case C-64/89
\textsuperscript{137} Case C-48/98
Through electronic payments, technology could permit direct payments of VAT when the transaction takes place. Or, technology could also ensure that there is an automatic reconciliation in between the VAT duties of companies within the production chain. If the new technological processed worked smoothly then there would no longer be a need to replace the current zero-rating as the electronic checks would become replacements of the former border controls.

Finally, it is important to understand that all these solutions require substantial technological investment costs but, seen in the light the current VAT losses, these investments would undeniably pay back.

### 8.1.2. RTvat

This system would move the point of taxation from the invoice date to the settlement date and would also dispatch tax amounts from the debit cards and would wire transfers directly to the tax authorities when payments are made.\(^\text{138}\) The proposal does however only apply to goods and not also to tradable services. By employing such a system, the EU VAT would become more of a direct payment mechanism rather than a withholding procedure (as it can be currently considered) and the sellers that are involved in business-to-business transactions would not receive the purchasers’ VAT payments. Thus, at the moment of the payment, RTvat would remove the amount generated by the VAT rate and would send it straight to the tax authorities while the seller would only receive the amount covering his price and a notification that the tax amount had been sent to the authorities.\(^\text{139}\)

In the particular situation of business-to-consumer trade, RTvat needs to be adjusted for the payments not made with debit / credit cards. In case the consumers pay in cash or with checks, the seller needs to cover the payment of the VAT and this takes place when he deposits the cash or the checks.\(^\text{140}\) These two means of payment would then be divided into the relevant VAT amount which would be transferred directly into the account of the tax authorities and the part correctly pertaining to the seller (the price of his supplies) that would be transferred to his account.

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\(^{138}\) Ainsworth, R.T. (2011a)

\(^{139}\) Ainsworth, R.T. (2011a)

\(^{140}\) Ainsworth, R.T. (2011c)
This system has not yet been implemented in the EU but it has been used within Latin America, in Argentina, Chile, Colombia, Ecuador, Mexico, and Venezuela.\textsuperscript{141} For the EU, there was a proposition to introduce PVAT (prepaid VAT) which mandates sellers to collect VAT on all sales (domestic and cross-border) excepting the cross-border sales in which the buyer prepays the VAT to the state of destination and provides the vendor with a tax deposit receipt which would be considered a proof of payment.\textsuperscript{142} If the buyer does not present this proof then the cross-border sale will be taxed.

RTvat functions due to a network of 27 identical servers (one corresponding to each EU Member State) that are linked together as transfer centers for communications and funds.\textsuperscript{143} In order for this to function, each EU Member State needs to set up a national server system through which all the VAT payments would need to go. All the banks that are involved in the tax settlements of such trade will need to establish a secure link with the network of servers. This technology fights the VAT gap as follows\textsuperscript{144}:

- It improves the sharing of information through real time data sharing among the Member States;
- It provides leading edge fraud analysis by having embedded in the system several tools especially created for identifying unusual transactions and fraud. The transactions that are categorized as suspicious can be marked for further analysis and also the VAT refund can be blocked until the resolution of the investigation.

If this system is to be implemented in the EU then it should go through a two step process. First it needs to be put into operation for the domestic trade of a Member State. Afterwards it would expand to the Intra-Community transactions (where it would hopefully succeed in fighting MTIC fraud). In order to achieve the fraud elimination, this technology requires a single VAT registration across the EU. The business buyer would always pay domestic VAT on purchases (including the Intra-Community ones) while there will be no reverse charge and the cross-border sales will be taxed at the applicable rate in the buyer’s jurisdiction, not zero rated by the seller with the anticipation that the buyer will execute a reverse charge.\textsuperscript{145}

\begin{flushright}
\textsuperscript{141} Ainsworth, R.T. (2011a) \\
\textsuperscript{142} Poddar, S. and Hutton, E. (2001) \\
\textsuperscript{143} Ainsworth, R.T. (2011a) \\
\textsuperscript{144} Ainsworth, R.T. (2011c) \\
\textsuperscript{145} Ainsworth, R.T. (2011a)
\end{flushright}
One downside of this technology is the fact that companies would no longer be able to use the collected VAT as a cash flow until the moment when they have to remit it to the authorities.

8.1.3. VLN

Another suggested technology would be the VAT Locator Number (VLN). In major lines, it seems the simplest solution among the detailed array of three technological solutions and the least disruptive to the present VAT system. It is more targeted than the other two and it specifically aims at eradicating MTIC fraud. It can even only be implemented in one Member State so as to fight MTIC without needing the collaborating with the other states.\(^{146}\) In order for the scheme to function, businesses would need to set up a valid encrypted VLN and then print it on the invoices that they generate when selling supplies (either numerically or as a bar code which can afterwards be scanned and read with optical readers).\(^{147}\) Each VLN is unique to each separate transaction and is based on the fundamental data in the invoice plus related VLNs from transactions up the commercial chain.\(^{148}\) If it is appended as a bar code then the benefit is that optical readers can rapidly check the code in the central databases.

Generally, the compliance process would be totally automated as the accounting software would take on all the work of requesting VLNs from the central authorities and also validating them when needed. Each link in the commercial chain will be assigned with a number, and the numerical progression will follow the goods (or services) from initial manufacture through to final consumption.\(^{149}\) VLN technology rejects a buyer’s input credit if the VAT is paid on an invoice without VLN or with one that is not valid. If a trader sells without a VLN then the next trader in line would pay the VAT straight to the tax authorities so as to make sure that he can resell the supplies that he purchased. As a consequence the company that sold without a VLN will receive no VAT and would also most likely be penalized, plus it would become more difficult for it to secure a VLN for the future transactions as it would require a more detailed risk assessment.\(^{150}\) MTIC would this way be wiped out and the commercial process would be carried out without disruptions.

\(^{146}\) Ainsworth, R.T. (2011b)  
\(^{147}\) Ainsworth, R.T. (2011b)  
\(^{148}\) Ainsworth, R.T. (2011b)  
\(^{149}\) Ainsworth, R.T. (2011b)  
\(^{150}\) Ainsworth, R.T. (2011b)
Such a system is already in place in Brazil and it seems to be working perfectly.\textsuperscript{151}

\subsection*{8.1.4. D-VAT}

Digital VAT (D-VAT) includes certified tax software and a modification of the standard place of supply rules and could be used in order to eliminate MTIC fraud. Similarly to VLAN, D-VAT alters the trader that needs to pay the VAT according to whether the companies involved in the trade use certified tax software.\textsuperscript{152}

As VLN shifts the responsibility of remitting the VAT according to the existence / non-existence of a VLN code on the invoice, D-VAT does the same but according to the existence / non-existence of certification for the enterprise tax software. What the software needs to do is to:

\begin{itemize}
\item ‘determine the correct tax for each transaction;
\item post that amount on the appropriate invoice;
\item link each VAT input or output amount to the correct VAT return; and
\item complete the VAT return accurately.’\textsuperscript{153}
\end{itemize}

In addition to that, this software would also need to check whether the system of the other party in the trade is also appropriately certified. The use of such software could be both voluntary and mandatory (mostly for the businesses dealing with trade that is predisposed to MTIC fraud).

If used, this mechanism would involve nearly instant dual notifications of certified status, all delivered through a secure online connection.\textsuperscript{154} One of the most functional infrastructures is PKI (public key infrastructure) which ‘enables users of a basically non-secure public network (such as the Internet) to securely and privately exchange data through the use of a public and private cryptographic key pair that is obtained and shared through a trusted authority.’\textsuperscript{155} For D-VAT, the trusted authority would become the Member State that certifies the transaction tax software in the company that requires it. These notifications need to be dual so that each party would be assured that it is dealing with a certified trader and can trust the information in the invoices.

\begin{thebibliography}
\bibitem{Ainsworth2011b} Ainsworth, R.T. (2011b)
\bibitem{Ainsworth2011a} Ainsworth, R.T. (2011a)
\bibitem{Ainsworth2011b} Ainsworth, R.T. (2011a)
\bibitem{Ainsworth2011b} Ainsworth, R.T. (2011a)
\bibitem{Ainsworth2011a} Ainsworth, R.T. (2011a)
\end{thebibliography}
Based on the requirements for the proper functioning of such a system, there can be four combinations when a taxable transaction takes place between two traders (A selling to B) across their borders. Under the current conditions, the sale would be zero-rated when exiting the state borders of A and would fall under a reverse charge demand when entering B’s state.

- **A & B are both using tax certified software.** The transaction would work perfectly and there would be no place for MTIC fraud as the zero-rating and reverse charge would happen as they theoretically should and the authorities would receive the correct VAT.

- **A is not certified & B is certified.** Since B is certified then B will be allowed to perform the reverse charge. In the case of A, it might not be allowed to make use of zero-rating especially if it is dealing with transactions suspect of MTIC fraud. There is nevertheless, the possibility that the authorities in A’s state would consider the fact that B is certified as a proof that A undertook a due diligence exercise to ensure that B is not involved in MTIC and would grant A the right to zero-rate the transaction.

- **A is certified & B is not certified.** This is a very difficult situation for B as A’s software would notice the situation and would not allow for the zero-rating of the trade if it relates to questionable supplies. B would then need to pay the domestic rate in A’s state but also to follow the reverse charge enforced within its own borders. Thus, B would suffer a double taxation or, even though quite complex to get, it could gain a refund from A’s jurisdiction. Being in such a situation, B would probably shift to a domestic supplier or would also start using a certified software.

- **A & B are both not using tax certified software.** In the case of suspicious supplies, A would not be allowed to claim VAT on the suspect supplies that it purchased and would also need to collect the VAT on all its sales of these products. In the case of B, it would need to collect VAT through reverse charge.

### 8.2. Measures not Aimed at Modifying the VAT System

In addition to the suggestions related to improving the VAT mechanism there have been a series of other methods that would help prevent the fraud.
• **Prevent ‘missing traders’ from entering the VAT system.** This method would involve a better check of the companies in order to discover the sham traders that apply for registration numbers solely in order to perform fraud. This would mean an increased control at the time of registration of suspect traders. This control would also be related to measures which permit the tax administrations to require financial guarantees, monthly VAT returns or special visiting programmes on suspect new traders.\(^{156}\)

• **Stop detected missing trader fraud.** By this set of actions, the authorities should combine the identification of fraud with withholding of VAT refunds to the purchaser while the result of the investigation is under way. On this account, several Member States have already modified their legislations in relation to VAT refunds. It is also important that the VAT numbers of the missing traders should be annulled as soon as possible so as to avoid that these traders continue buying goods without paying VAT and thus to stop the fraud process.\(^{157}\)

• **Denied recovery of VAT in cases of fraud.** This measure is somewhat more extreme as it stipulates that since the authorities cannot recover VAT from the fraudulent traders, no other taxable persons implicated in the fraud should be able to recover their VAT.\(^{158}\) To some extent, in practice, this proposal is translated into the ‘joint and several liability’ and the ‘knowledge test’.

• **Increasing the cooperation of the taxpayers with the tax authorities.** This relationship goes both ways as it does not only cover the obligations of the taxpayers (reporting, payment, auditing) but also the quality, reliability and accessibility of information provided by tax authorities.\(^{159}\) The Commission has suggested more dialogue in between the tax authorities and the stakeholders (through a possible permanent forum), sharing the best practices of the Member States (e.g. draft guidelines to streamline the administrative processes and abolish unnecessary burdens on businesses), drafting a new EU policy which would require voluntary compliance through specific arrangements with stakeholders (e.g. setting up ‘partnerships’ in between the tax administrations and

\(^{156}\) COM(2004) 260 final  
\(^{157}\) COM(2004) 260 final  
\(^{158}\) COM(2004) 260 final  
\(^{159}\) COM(2010) 695 final
the taxpayers and making use of prior rulings on the tax treatment of certain transactions), adapting the IT tools (e.g. facilitating automated information transfer between taxpayers and the tax authorities, creating specific software to be maintained at EU level and made available to all Member States).\textsuperscript{160}

The Commission has also taken action to improve the cooperation of the Member States through, notably, the Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties, and other measures. It is a very important part of the Commission’s plan to fight fraud. The first version was enacted in March, 1976 and suffered several modifications up to the most recent version which takes the form of Council Directive 2010/24/EU. According to it, ‘at the request of the applicant authority the requested authority shall provide any information which is foreseeably relevant to the applicant authority in the recovery of its claims’\textsuperscript{161}. There is no escape for the requested tax authority which would need to reply even in case it surpasses bank secrecy. No information can be denied exclusively because it is held by a bank, another financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.\textsuperscript{162}

In major lines, the Directive aims to standardize practices and it has three main components\textsuperscript{163}:

- **Exchange of information.** In addition to the traditional means of exchanging information, it is now required for this process to happen spontaneously. As a result, officials from applicant Member States can attend administrative enquiries going on within the territory of the requested states.

- **Notification documentation.** Standard forms of notifications are created and Member States need to support each other in order to guarantee the correct proceedings of tax, audit and judicial notices within their territories.

- **Assistance in the recovery of claims and precautionary measures.** Again, the Directive emphasizes on standard instruments for the enforcement of claims and precautionary procedures. This comes as a result of the high speed of MTIC fraud which, in turn, requires a speedy reaction from the authorities, avoiding delays in the enforcement of claims.

\textsuperscript{160} COM(2010) 695 final
\textsuperscript{161} Council Directive 2010/24/EU
\textsuperscript{162} Council Directive 2010/24/EU
\textsuperscript{163} Council Directive 2010/24/EU
The set of rules mentioned in this Directive are accompanied by numerous exceptions. Therefore, one needs to pay good attention to all the details included in the text. In addition to that, in terms of costs, their recovery can be charged to the taxpayer if the amounts incurred are not freely paid.\textsuperscript{164} Plus, assistance through this system is not compulsory for the claims older than five years or under €1,500.\textsuperscript{165}

9. Carousel Fraud and Alternative VAT Regimes (VAT According to the Origin Principle, the So-called VIVAT, etc.)

In addition to the solutions mentioned above there have also been discussions about introducing alternatives to the current VAT system and shifting to an exporter rating approach (taxation of Intra-community exports by exporting Member States and the use of this gathered revenue to finance equivalent tax credits provided in importing states). In major lines, the alternative regimes are VIVAT (Viable Integrated VAT), C-VAT (Compensating VAT), Dual VAT (Dual EU and local VAT), PVAT (prepaid VAT) etc.\textsuperscript{166}

9.1. VIVAT

The concept was introduced by Keen and Smith in 1996 and involves provinces imposing the same tax rates on all the sales to registered traders everywhere in the federation.\textsuperscript{167} Nevertheless, the rates applicable to the final sales towards consumers and non-registered traders will still be decided by each province.\textsuperscript{168} Applied to the EU, this would mean a common VAT rate within the whole EU and an additional retail tax which is imposed separately by each Member States at the moment of final sales. VIVAT does, thus, not separate the local and cross-business trade but rather the business-to-business from the business-to-consumer transactions. By following this method, there would be no need for a clearance for the business-to-business transactions as they would fall under the same tax percentage and would even themselves out unless the VAT collected on exports exceeds the VAT credit given to importers. In our case, this method would also reduce the missing trade fraud cases as the fraudsters would not be able to make any fraudulent gains since they had already paid VAT on their purchases. Another benefit could also be the fact that traders would be

\textsuperscript{164} Council Directive 2010/24/EU
\textsuperscript{165} Council Directive 2010/24/EU
\textsuperscript{166} COM(2010) 695 final
\textsuperscript{167} Keen M. (2000)
\textsuperscript{168} Keen M. (2000)
able to report their exporting and importing activities in aggregate as opposed to presenting them per Member State.

Looking into the Member State specific sales tax, this would allow each state to decide on its own tax percentage. In order to fix the issue of unequally distributed revenues, the Member States could decide to implement a revenue-sharing system but that would only generate more administrative burden.

Even though it generally sounds like a good alternative to the current system, VIVAT also has several flaws. First of all, there would still be hindrances in the VAT audit trail as the national authorities in the importing states would not have the necessary authority to audit the importers’ invoices which were received from the exporters from the other Member States. The problem could easily shift from fake export invoices to fake import invoices as traders might feel inclined to present unrealistic VAT eligible for credit (while in the current situation these invoices show zero VAT). Looking deeper into the VIVAT proposal of keeping track of the trade by businesses rather than individual transactions, this would also impact the monitoring process as it would become very difficult to link the individual transactions. It would help with the treatment of triangular and chain transactions but it could set hurdles to the treatment of inter-company transactions.

Looking into the current VAT rates within the EU, it is simple to spot the fact that the Member States have uneven appetites for their levels of VAT rates. By introducing VIVAT, the aim of perhaps reducing these VAT rates at a future point in time seems highly unattainable. There would also be difficulties with the reduced VAT rates that are applied to only specific products. Used in the chain of transactions these would complicate VIVAT and would probably create new fraud opportunities in light of the impracticable VAT audit trail.

Additionally, businesses would need to gather more information about their clients in order to ensure that this system is applied properly, fact which would translate into higher business costs. There would also be higher compliance costs for the Member States that would apply the supplementary retail sales tax in comparison to the Member States that would only enforce the common Intra-Community VAT rate. They would consequently have to apply two different rates according to their trading partner. Concerning the sales to private, non-business customers, the traders would need to establish the country of residence of their customers and then add the respective country sales tax to the applicable VIVAT rate. Nevertheless, the percentage of final cross-border sales compared to the business-to-business ones is relatively low.
There is always the risk that the buyers would falsify their country of residence in order to enjoy the lowest sales rate. Fighting this phenomenon would involve harmonizing the Member States’ sales rates which would, in turn, decrease their level of autonomy. In addition to that, if the sales rates would be completely harmonized then the whole concept of VIVAT would be redundant as one rate would apply for all the Member States. If the sales rates would be zero then VIVAT would basically turn into reverse charge.

In comparison to the zero rating system, VIVAT brings along a considerable administrative burden and also runs the risk of violating the tax autonomy of the Member States as it would require a central authority which would settle the VAT balances.

9.2. CVAT

Compensating VAT (CVAT) was initially introduced by Varsano in 1995. The concept advocates that the inter-provincial sales should continue to be zero-rated for VAT but one should add a ‘compensating VAT’ to the sales in between the provinces.\textsuperscript{169} In terms of the value of such a rate, a very low one would trigger an unnatural incentive to import, while a high one would increase the fake refund claims. Therefore this should be around the average of the provincial tax rates which might, in its turn, require various CVAT rates according to commodities if there are variations in the general VAT. It all sounds applicable and favorable except that the CVAT is paid to the exporting state, while the internal sales tax is paid to, in this case, the importer. In other words, due to the imbalanced trade within the EU, it is very likely that some Member States would collect more taxes than others as they will be exporting more than the others.

Among the drawbacks of such a system one can mention the infringement of the compliance symmetry, as the inter-provincial trade (under CVAT and federal VAT) will be taxed differently from the intra-provincial trade (under provincial and federal VAT).

Looking into all the suggested approaches, it is noticeable that rather than trying to come up with multiple and diverse systems for the VAT treatment of Intra-Community trade, the focus should lie of improving the VAT audit trail. The Commission needs to look into the breaking point of this audit trail and impose new solutions for a better monitoring of compliance plus more action against the fraudsters.

\textsuperscript{169} Keen M. (2000)
9.3. General Analysis of the Alternative VAT Regimes

Looking at the VIVAT system, it becomes clear that the business agents would need to classify their sales into three: sales to registered persons within the EU (subject to the EU-rate), sales to unregistered persons within the EU (subject to the higher Member State rate), and sales for export outside the EU (subject to the zero rate). VIVAT and CVAT would also require a clearing house which might prove hard to achieve from a political viewpoint plus that it might give rise to additional reporting obligations. Also, there will be a need for adjustment in the cases where VIVAT and CVAT rates differ from the national rates. Finally, they may solve the break in the VAT collection chain but they do not solve the VAT-audit trail break. Importing Member States would still not have the possibility to audit the invoices of the importers that are received from exporters in other Member States for which they lack authority.

In general, I believe that the problem of the current VAT system is not the break in the VAT-collection chain but the break in the VAT-audit trail. I consider that this could be addressed by cross-border audits and subsequent trial actions. Shifting the current system to those described above would merely move the fraud from the export phase to the import phase as traders could create fake invoices for VAT credit purposes.

10. Conclusion

The international aspect of trade is particularly important in the VAT implementation. The completion of a single market facilitated the international trade and new forms of trade also came to life (e.g. e-commerce, cross-border services). The recent developments have reflected weak points in the current VAT system and called for its redesign or for alternative mechanisms. In order to ensure its best usage, debates have been held whether international transactions should be taxed in the country where consumption happens (destination principle) or where the production takes place (origin principle). For now, as a transitional choice, it has been decided that the destination principle would be the most suitable given the conditions in place. By applying it, businesses and final consumers do not feel any difference in between imported goods and those produced within their countries. Similarly, when importing, they are not impacted by the VAT rates which differ according to the Member State as they pay the VAT rate in use within their country. Several propositions had been made so as to shift from the transitional regime to a final one based on the origin principle but none of
them was accepted. Among the reasons why the origin principle would be hard to implement, one could mention:

- The need for a close harmonization of the VAT rates which influence the buyers with regard to the state in which they perform their acquisitions.
- The need for a clearing system which would make sure that the collected VAT would be distributed to the correct state of consumption.
- The need for a better cooperation in between the Member States as they would depend on each other when gathering their corresponding VAT revenues.

Based on the destination principle, the issue that arises is the difficulty of keeping track of the transactions in a Union which abolished the border controls. In order to make sure that the goods are only taxed in the country of consumption, the VAT system zero-rates exports, fact that means that they are free of the VAT incurred on the supply chain up to the point of export. Consequently, all imports are subject to tax. But zero-rating creates very good opportunities for fraud. The tax authorities end up paying high amounts for the VAT refunds made by companies on the inputs that they use for zero-rates sales. This is the birthplace of MTIC (Missing Trader Intra-Community) fraud and, more specifically, carousel fraud. This type of fraud is quite well known both due to the complex forms that it takes and due to the speed with which people become prosperous because of such schemes. In short, goods are purchased zero-rated but afterwards sold with VAT. The purchaser does claim the VAT paid but the seller disappears before remitting the VAT collected to the authorities. If this scheme happens multiple times with the same products taking part in the same fraud several times and making multiple trips across the borders of the Member States (such as a rotating carousel) then it is called carousel fraud and it becomes more vicious than the simple form of MTIC.

Even though early MTIC fraud has been more frequent with goods, it is important to also acknowledge its appearance within the services in the case they are bought and sold as goods, tradable services (carbon emissions, VOIP etc.). The complexity existing within services is the fact that they disappear once consumed.

The zero rating of exports interferes with the concept of gradual buildup of VAT through each transaction with the production and distribution chains. Because of that, the chances for fraud are increased. From the tax authorities’ point of view, they do not only receive lower tax revenue, but they also end up paying VAT
for the inputs purchased by the trader. Nevertheless, it can be argued that it is not the system itself that should bear the blame but rather the faulty exchange of information in between the Member States. In other words, there is no clear VAT audit path which would enable the Member States’ authorities to identify and control the compliance process. The Commission should keep its focus on a practical system which extends the VAT audit trail across its borders thus making sure that all the transactions are properly accounted for.

One of the goals of this thesis is to explain the methods that could be used in order to fight the MTIC fraud. The methods are detailed and examined from an advantage / disadvantage perspective of implementing them. Nevertheless, in order to understand the complex forms taken by MTIC, the thesis also presented several Court cases, their facts, their legal proceedings and the conclusions. These conclusions are essential within the anti-MTIC scope as they become grounds for future cases and future decisions.

The cases build on the principle of joint and several liability and on the knowledge test. According to the facts, a number of them hold the traders guilty of involvement in MTIC fraud and ask them to participate in the monetary fines through the perspective of joint and several liability with the organizers of the schemes. Other cases reflect that fact that some businesses can be exempted from punishments as they were not aware of their involvement in fraud. It might look straightforward at first sight but it is nevertheless very difficult to prove that traders are / are not aware, should have been / could not have been aware of the fraudulent character of their activities.

Looking deeper into two specific cases presented above, Case R is an extension of the Kittel case due to the fact that it uses similar grounds for denying zero-rating on Intra-Community supplies as Kittel does for the denial of input tax deductions. Kittel is based on the idea that the taxable person knew or should have known that he was involved in a transaction connected with VAT fraud. It does not request for the trader to actually be involved himself in fraud in order to receive a punishment. The R case is more ‘restricted’ from the viewpoint that the trader would be punished if there are true grounds to assume that his Intra-Community supply would avoid the payment of the due VAT at the destination. In comparison to Kittel (where the rule says ‘knew or should have known’ that he was involved in VAT fraud) and with Ricolta (where the rule again says ‘knew or should have known’ that he was involved in VAT fraud), R only has the rule of ‘knew’ or ‘didn’t know’ without the ‘should have known’ component. In the case of R, the authorities need to come
up with genuine reasons of fraud in order to withdraw the trader’s right to zero-rate his supply or even to retro-actively ask him to pay VAT on past supplies to other Member States.

One of the anti-MTIC fraud methods favored by the authorities is reverse charging. What it does is shift the VAT liability from the seller to the buyer. In case of zero-rated exports this approach would cut the refunds made by the state to sellers which afterwards do not pay VAT by simply reducing the payment liability of the buyer but not requiring actual payments from the states. As good a plan as it sounds, this method interferes with the concept of VAT as a gradual tax and it basically converts it into a retail sales tax. Some countries in the EU have been granted the right to introduce reverse charge for goods that are particularly sensitive to MTIC fraud (such as mobile phones, computer chips etc., generally goods that have a low volume and high prices) but other countries have been denied the right to apply such a measure in the EU. Reverse charge seems to be only a temporary solution that opens the way for fraud with other goods which are not within the scope of reverse charge.

The joint and several liability procedure also seems to be a useful weapon against fraud. However, implementing it can prove difficult as it is hard to demonstrate that traders were aware or should have been aware of the fact that they were involved in transactions belonging to a fraudulent supply chain. There is also a risk that honest businesses would suffer consequences without being guilty of any fraud or without being aware of their involvement in such schemes. But, all in all, it may become a reason for those willing to embark on such fraudulent schemes to rethink their actions and to refuse to go forward with evasion.

The knowledge test, one of the means of reducing the costs of VAT fraud in the case of MTIC is to recover the tax from other taxable traders which were involved in the fraudulent scheme (in the same transaction chain). Thus, if it can be proved that the customer was aware of his implication in a VAT evasion scheme then his right of deduction can be rejected by the authorities. However, this awareness needs to be proved for each particular case and can become time consuming, complex and costly. On the side of the traders, they become more exposed as they need to undertake supplementary verifications of all their suppliers and to be very careful about the new suppliers.

Among other solutions, one could also look into shifting from the destination principle to the origin principle where the exporters would pay their states the VAT due on their sales at the exporting state’s rate and importers would claim VAT from the importing country at its own VAT rate. The matter would then shift.
from businesses settling the VAT balance to countries cooperating and redistributing the revenues (the exporting states would be gaining revenues while the importing ones would be making a loss).

Another solution would be to introduce a single, common VAT rate within the entire Union for the cross-border trade and let each country add up their own specific VAT rates if they consider that necessary (similar to the retail sales tax) for the domestic operations. This solution itself comes into multiple forms as it can be applied only to exports (CVAT which requires the sellers to use dissimilar methods for the domestic and cross-border trade) or to all the transactions (VIVAT where traders need to differentiate in between commerce with businesses and commerce with final consumers). Setting up such systems would however require more administrative efforts and even a higher administrative authority to monitor the compliance. Nevertheless, these approaches could be good solutions as they would maintain the current destination principle, would resolve the VAT fracture in the cross-border trade and would also give the liberty to the Member States to use their own rates for the domestic activities towards the final buyer, thus deciding themselves on the amount of taxes that they would like to collect.

There are also several technological solutions which could help fight especially MTIC fraud. The three solutions presented are the following:

- **RTvat** applies to all the transactions and focuses on misalignment as the collection and recovery of VAT does not happen timely and efficiently. Thus, RTvat shifts the timing of the collection of VAT from the end of a period to the actual point of sale.
- **VLN** applies to all the transactions but does not change the current VAT system. It only builds on it and adds an encrypted code on each invoice.
- **D-VAT** has very similar results as VLN but, instead of adding a code, it requires companies to use certified tax software. This software is not mandatory and it can be applied to specifically to the supplies that normally fall within MTIC fraud.

Looking into the details of these proposals, there is substantial central control in the case of VLN and RTvat as the central computer systems need to keep track of each transaction (VLN) and payment (RTvat). D-VAT does not require this central monitoring as it provides assurance of accuracy in reporting through its certified software systems. In addition to that, VLN and D-VAT do not bring major changes to the VAT system currently in place, while RTvat does require the system to change into origin based. Finally, VLN and D-
VAT can be applied by each state at a time while RTvat needs to be adopted by all the states at the same time so as to function perfectly.

The alternative systems, VIVAT and CVAT have also positive and negative aspects. VIVAT would support a uniform VAT rate within the entire European Union, supplemented by a local retail sales tax. Thus, there would be a two-tier tax that would not separate the local transactions from the cross border ones but would make a distinction regarding the sales to businesses and to consumers. A good solution from afar, but a plan that could shift falsifying export invoices to falsifying import invoices in view of claiming higher VAT for credit. In addition to that, a solution that would bring a lot of administrative burdens both on the side of the authorities (harder to follow the audit trail) and of the traders (need to obtain correct information whether the trade partners are businesses or final consumers). In its turn, CVAT would maintain the destination principle and would reinforce the VAT chain while proposing a better zero-rating approach. If it is administered by a single agency (most likely a Community level agency), it would avoid dealing with a lack of incentives to gather information about transactions that don’t affect negatively the Member State who needs to do the work and would also avoid other administrative problems related to clearing in between the national tax administrations.

In conclusion, there seem to be choices to combat MTIC fraud but they all require specific tradeoffs. These tradeoffs may come in a monetary form, in increased centralization (thus less autonomy per Member States) or even with the risk of shifting fraud to other areas that are currently not affected by such fraud (through reverse charge). The outlook is nevertheless optimistic and, in time, such fraud should be reduced, if not totally abolished.
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**General Information**
