



Tax Faculty

TAXREP 30/06

VAT: MISSING TRADER AND CAROUSEL FRAUD IN THE EU

Written evidence submitted in October 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the House of Lords European Union Committee – Economic and Financial Affairs and International Trade (Sub-Committee A) in response to a call for evidence issued in July 2006

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FOREWORD

1. In July 2006 the House of Lords European Union Select Committee: Economic and Financial Affairs, and International Trade (Sub-committee A) decided to conduct an inquiry into the issues surrounding carousel fraud and issued a call for evidence. The document announcing the inquiry can be found at the following link:
http://www.parliament.uk/parliamentary_committees/s_comm_a.cfm.
2. The inquiry seeks to answer the following key questions:
 - What is the exact nature of VAT carousel fraud?
 - Are there gaps in legislation which allow this form of fraud?
 - What impact does this fraud have on the internal market?
 - What are the measures currently applied to combat this fraud and what are their weaknesses?
 - Are the mechanisms suggested by the Commission to fight this fraud adequate?
 - Are Member States, within the context of the internal market and the globalised economy, capable of fighting individually against this fraud or is it right for the Commission to bring forward proposals on their behalf?
 - Does the adoption of measures to fight VAT fraud at the Community level undermine Member States' control over the functioning of national fiscal systems?
3. The questions above cover a broad range of topics. In the interests of brevity it was pointed out in the invitation that there was no need for individual submissions to deal with all the issues.
4. The text of the written evidence prepared for and submitted to the Committee is reproduced below.

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TEXT OF WRITTEN SUBMISSION

WHO WE ARE

The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.

EVIDENCE

Introduction

1. The Tax Faculty of the Institute of Chartered Accountants is pleased to respond to the call for evidence by Sub-Committee A in its enquiry into the issues surrounding VAT carousel fraud.
2. It has always been possible for a person in business to disappear without paying VAT. As long as businesses collect tax which they are required to pay over to HM Revenue & Customs (HMRC) that possibility will always be present. MTIC fraud and carousel fraud however are on an altogether different scale. We agree that the prevalence of the MTIC fraud and the huge sums involved warrant urgent action and we support HMRC in their battle to eradicate it.
3. We understand that MTIC fraud is perpetrated by a relatively small number of people. By now they must have considerable assets which they have no doubt sought to hide. We assume that police detection techniques have been employed to identify the guiding minds of the fraud and their assets. Clearly sufficient resources must be allocated to this task. This is a crucial first step in reducing or eradicating the fraud.
4. Tax fraud undermines the tax system and sends the wrong message to those who pay their taxes. We support the provision of extra resources to fight this fraud. There is a need for specialists and the right type of resources.

The origin and cause of MTIC fraud

5. In theory VAT is a tax that is easy to collect and is to a large extent self policing. It is difficult to avoid or evade. Tax is collected from businesses at each stage of the production cycle. The tax at risk of fraud or non-collection is limited to the VAT on the value added by the last trader. However, in 1993 a departure from the normal VAT system was introduced which created the opportunity for MTIC fraud. MTIC fraud relies on the system of zero rating of goods supplied to a registered trader in

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another member state. Without zero rating for goods crossing the borders of member states MTIC fraud could not exist.

6. According to the Budget 2006 Red Book (Table C8 on page 262) the receipts for VAT for 2004/05 were £73 billion. The latest HMRC estimate for MTIC fraud is that it cost the UK between one and two billion pounds annually, although later estimates have put this up to £8 billion.
7. The Single Market system for accounting for VAT on movements of goods between member states is known as the transitional or destination system. No VAT is charged in the country from which the goods are despatched. Tax is accounted for under the destination system in the country receiving the goods. The re-introduction of border controls abolished at the start of the Single Market in 1993 is not a practical possibility and would not meet the objectives of the Treaty to create a common market identical to an internal market.
8. In planning the Single Market, the Commission pointed out the danger that the VAT-free transfer of goods between taxable persons in different member states gave rise to the possibility that some of those goods would leak into free circulation without tax being paid. It thought that the destination system was prone to abuse and evasion.
9. The Commission recommend the origin system under which VAT is charged in the country of despatch and the trader in the other member state reclaims the tax in his own country just as for domestic transactions. That way, no movements of goods would be VAT-free. However, a means had to be found to give the business in the country of acquisition relief for tax paid in the country of despatch. To do that the Commission proposed a clearing system. That was rejected for a number of reasons, including that of political sovereignty. Operationally, it was claimed it would be too complicated and too costly to operate. It was of course nowhere near as complex as the clearing systems operated by banks and credit card companies. The cost of the system is likely to have been relatively insignificant compared to the cost of the fraud that has taken place since 1993.
10. The destination system is known officially and in the Directive as the transitional regime. The Commission still favours the origin system as the definitive regime and if the Community wishes to move to a true single market that is identical to an internal market some form of clearing system is inevitable. We think the UK and other member states should review their objections to both a clearing system and the origin system in the light of experience since 1993. A number of misconceptions entered the decision-making process in the early nineties. For example the harmonisation of rates of tax in member states is not essential in order to operate the origin system as was previously thought (although it makes it simpler). A clearing system would pave the way for the single VAT registration of traders operating in more than one member state and would complete the internal market - a cherished objective of the Community. We think there should be a review of the practicability of a clearing system and whether it will reduce the risk to the collection of tax. The objective is to strengthen the structure of the tax and to make the revenue derived from it more secure. However, we recognise that any move to an origin system will

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take time. Accordingly, other more short term solutions are necessary to fight MTIC fraud and we consider these below.

How MTIC fraud works

11. In its simplest form MTIC fraud is carried out by a VAT-registered trader who acquires goods from a VAT-registered trader in another member state. The goods enter the UK VAT free and they are then sold to another business in the UK and VAT is charged on that supply. The supplier then disappears without paying the tax. If the UK business customer supplies the goods to another VAT-registered trader in another member state the same goods can leave the UK and then be brought back to the UK where the fraud can be repeated. The UK business customer may or may not be aware of the fraud. The goods may or may not actually cross the borders of member states and the paperwork purporting to evidence such movements may be false.

Action to protect innocent traders

12. Guidance has been published by HMRC to help traders avoid being unwittingly involved in MTIC fraud. Some may be naïve, gullible or greedy but otherwise innocent traders who are more likely to be caught up in fraud. They should be treated as compliant traders unless there is evidence to the contrary.
13. In the linked cases of *Optigen* (Case C- 354/03), *Fulcrum Electronics* (Case C- 355/03) and *Bond House Systems* (Case C- 484/03) the European Court of Justice held that transactions not otherwise vitiated by VAT fraud constitute supplies of goods for VAT purposes. They are an economic activity regardless of the intention of someone else involved in the chain of supply and/or the possible fraudulent nature of another transaction in the chain either before or subsequent to the transaction carried out by the taxable person and about which he had no knowledge and no means of knowledge. The three companies submitted VAT returns claiming large repayments arising as a result of purchases of computer processing units. HMRC rejected the claims on the grounds that the purchases formed part of a carousel or missing trader fraud designed to obtain repayment of large sums that had never been paid as output tax. HMRC argued where goods move in a circle of transactions through the same chain of companies for the purpose of stealing VAT, there is no economic activity and no VAT is payable or repayable on the transactions. The ECJ rejected this argument and found that transactions within a fraudulent trade can fall within the Directive and within the scope of the tax. On 18 January 2006 the Commissioners issued Business Brief 01/06 setting out their practice in the light of the Court's decision.

New reverse charge

14. In our briefing paper to MPs relating to the Finance Bill this year we welcomed the proposal to apply to the European Commission for a derogation to introduce the reverse charge. We note that the Commission have now proposed this, although it still has to be approved by the Council. We agree that the reverse charge is useful (we recommended its adoption in 2003), although it can only be a partial and temporary solution to the problem.

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15. There is a risk that the fraudsters may quickly turn their attention to goods not subject to the proposed reverse charge and/or to services. Secondly, we have a number of concerns on the detailed application, speed of introduction and the consequent burdens on business generally. For example, we consider that the £1,000 *de minimis* limit is far too low, since the average transaction involved in the fraud appears to be well over £100,000. We also think it preferable not to require retailers to operate the reverse charge on their supplies because it would be difficult for the fraudsters to carry out MTIC fraud by operating as retailers.
16. HMRC accept that the reverse charge introduces a further weakness into the system, since it defers payment of tax to the Exchequer until the last link in the chain of supply, where the whole of the tax charged to the consumer is at risk of non payment. Under the normal VAT regime tax is paid to the Exchequer at each stage of the production cycle and the tax at risk is only the amount of tax on the value added at each stage.

Further action

17. In the following paragraphs, we list a number of further measures which could be introduced to counter the fraud. Since all of them would place some additional burdens on innocent businesses, HMRC would need to be certain that they could operate them promptly and efficiently.

VAT registration

18. HMRC quite properly need to carry out checks to ensure that the applicant is a legitimate business. However, there is also a need to register legitimate businesses quickly and efficiently. At present, the delays in VAT registration are unacceptable, and hold back the development of new businesses.
19. Commercially available information, such as that provided by the credit agencies, may assist in building up a risk profile. It might also be useful in relation to changes of ownership and transfers of going concerns. Fraudsters can avoid registration checks by taking over an existing business already VAT registered.

'Credit limit' for input tax recovery

20. When a businesses files a VAT Return making an unusually large VAT repayment claim, HMRC will carry out a credibility check before authorising the repayment. In MTIC fraud, the claimant is not the fraudster himself, but often the business that purchased the goods from the fraudster. If that business is not involved in the fraud, HMRC are faced with an impossible task at that stage - the fraudster has already charged VAT to the business, collected it and disappeared.
21. We have suggested to HMRC that they could consider a limit (like a credit limit) on input tax claims for a VAT return period. If the limit is going to be exceeded the trader should be required to notify HMRC in advance and obtain their approval. Failure to give notice would mean a delay to the repayment whilst a thorough investigation is carried out.

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22. We recommend that the limit be set at a generous level so that the trader will only rarely have to give notice of an unusual claim such as when he buys premises or there is a major change in trading. For example a business whose input tax claims average £50,000 for each VAT Return period could be given a limit of £100,000. A transaction limit could also be set.

Transfers of going concerns

23. A fraudster involved in MTIC fraud may prefer to take over an existing VAT registration in view of the delays in obtaining a new VAT registration. We think that checks, similar to those made on new VAT registrations, should be made when there is a transfer of a going concern. There is already a requirement to notify HMRC within thirty days of the change of ownership. HMRC could consider whether it would be useful to require the transferor to obtain clearance from them in advance, and to specify the nature of the new trade.

Change of control of companies

24. HMRC could consider introducing a requirement for a controlling shareholder to notify on the sale of a controlling interest. For this purpose the controlling shareholder's holding should be treated as including those of connected persons. Until such notification, the controlling shareholder would be responsible for the VAT obligations of the company. We think that checks similar to those made on a new VAT registration should be carried out where there is a change in the control of a company.

Joint and several liability

25. Since 2003 there has been a new joint and several liability relating to the supply of specified goods (computers, telephones etc.). A taxable person who supplies specified goods can be held liable for VAT on a previous or subsequent supply of the same goods where he knew or had reasonable grounds to suspect that the VAT would go unpaid.
26. In practice we think that this is a very difficult liability to enforce in the case of those involved in MTIC fraud. The necessary evidence is not normally available.

HMRC's Nemesis Database

27. We think that the operations designed to capture data on unique identifier numbers in relation to mobile phones will have an impact in reducing fraud involving the goods identified. Unfortunately, it requires a great deal of administrative work, and may only divert the fraudsters towards other goods.

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6.10.06