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**VAT Frauds in the European Union:
The Reverse Charge Mechanism,
Joint and Several Liability
and the “Knowledge Test”**

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Abbreviations

Commission	Commission of the European Communities
Council	Council of the European Union
ECJ	Court of Justice of the European Union
EU	European Union
GST	Goods and Services Tax
OECD	The Organisation for Economic Co-operation and Development
OJ	Official Journal of the European Union
RVD	Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (the Recast VAT Directive)
Sixth Directive	Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment
UK	United Kingdom
Value Added Tax	VAT

1. Introduction

1.1 Background

Value Added Tax (VAT) is probably the most important tax in the European Union (EU). It has been very successful since 1967 when the Member States of the European Economic Community, now the EU, agreed to take up the common VAT system. Since then, more than 150 countries worldwide have adopted VAT or Goods and Services Tax (GST). VAT is particularly effective for raising revenue and it accounts for 18.7% of the tax revenues of OECD countries in 2008, but for 21% of the EU Member States in 2009 or around €784 billion. Tax revenue from VAT was on average 7.4% of the GDP of the EU Member States 2009 but on average 6.5% of the GDP of the OECD countries. One of the factors that has contributed to the success of VAT is that it has been viewed as a neutral tax with respect to international trade and that is a desirable feature in today's free-trade globalisation model. VAT is also considered to be directly associated with the development of the internal market of the EU.¹

In light of this it is not surprising that VAT fraud is a major concern for the EU and the Member States² as it is considered a major factor in the VAT gap that was estimated to be 12% as a share of theoretical VAT liability in 2006 or €106.7 billion. The VAT gap is for example also attributed to insolvencies and widespread weaknesses of the EU VAT system. It seems to be hard to find reliable information about how big a part of the VAT gap is a result of VAT fraud according to a study on the VAT gap that the Commission published 2009. An estimate from the United Kingdom (UK) states that VAT losses from fraud, avoidance, and general non-compliance were between £7-10 billion on the financial year 2001-2002.³ The interest that the EU has in fighting against VAT fraud and making the VAT system simpler and more effective can be seen in many communications and reports from the Commission to the Council, the European Parliament and the European Economic and Social Committee. Besides the negative impact that VAT fraud

¹ OECD Consumption, 'Consumption Tax Trends 2010 VAT/GST and Excise Rates, Trends and Administration Issues'(OECD Publishing 2011 <<http://dx.doi.org/10.1787/ctt-2010-en>> accessed 27 April 2012 p. 64, 70-71); Eurostar, 'Taxation trends in the European Union, Data for the EU Member States, Iceland and Norway, Edition 2011(Annex A, Publication Office of the European 1 July 2011 <http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-DU-11-001/EN/KS-DU-11-001-EN.PDF> accessed 27 April 2012, Tables 7 and 8); Commission, 'Communication from the Commission to the European Economic and Social Committee on the Future of VAT Towards a Simpler, More Robust and Efficient VAT System Tailored to the Single Market' COM(2011) 851 final, p. 3.

² Commission, 'Explanatory Memorandum with the proposal for a Council Directive amending Directive 2006/112/EC as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain goods and services susceptible fraud' COM(2009) 511 final, p. 2.

³ Reckon LLP, 'Study to quantify and analyse the VAT gap in the EU-25 Member States' (Report, Published by the European Commission 2009 <<http://go.reckon.co.uk/a29587>> accessed 29 April 2012), tables 1, 2 and 44 and para 342-356.

has on Member States revenue the fraud may also weaken the function of the internal market as it leads to distortions of competition between those paying VAT and those who do not.⁴

1.2 Purpose

In this thesis VAT fraud in the EU will be discussed and two methods the EU Member States have been using in the fight against the fraud and one method that ECJ has introduced by its judgments. These methods are the reverse charge mechanism, joint and several liability and the “Knowledge Test.” Those methods will be described and discussed how they are used to decrease VAT fraud. The pros and cons of these methods will be discussed and analysed, whether they can work together, or if they work against each other.

1.3 Disposition

Chapter 2 gives an overview on VAT fraud and specially the MTIC fraud and carousel fraud. In chapter 3 is the reverse charge described and how it deals with MTIC fraud. The pros and cons of this method are discussed in chapter 3.3 and in chapter 3.4 is covered an analysis from the Commission on a general reverse charge. Chapter 4 is about a joint and several liability and there is discussed how it can be used to fight VAT fraud. There is also given review over ECJ cases. The pros and cons of this method are discussed in chapter 4.2 and chapter 4.3 is about a proposal for EU-wide joint and several liability rules. In chapter 5 the “Knowledge test” is described and given reviews over ECJ cases and pending ECJ cases. The pros and cons of the Knowledge Test is discussed in chapter 5.2. Chapter 6 is about how those three methods work together. Chapter 7 gives a summary over this thesis.

1.4 Method and Material

This thesis is based on a legal study.

Materials used are EU legislation, EU case law from the European Court of Justice (ECJ), British and Belgian legislation, scholarly literature, articles and papers, reports, communication and papers from the European Commission, working papers from the European Commission staff and reports from OECD, Eurostat, Reckon LLP and the House of Lords in United Kingdom.

2. VAT fraud

VAT can be evaded or fraudulently exploited in miscellaneous ways and to derive overview over them it is helpful to categories them.⁵ One simple way is

⁴ Commission, ‘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’ COM(2006) 254 final, p. 3.

⁵ Michael Keen and Stepen Smith, ‘VAT Fraud and Evasion: What Do We know, and What Can be Done?’ (IMF Working Paper, International Monetary Found 2007 <<http://www.imf.org/external/pubs/cat/longres.aspx?sk=20215.0>> accessed 2 May 2012), p. 7-12.

to sort them in to two main categories: black market fraud and Missing Trader Intra-Community (MTIC) fraud.

Black market fraud: Black market fraud is when businesses do not file VAT returns, they understate the value of their sales or overstate their input VAT claims.⁶

Into these categories fall many types of fraud and often they are known under other names, such as, *under-reported sales fraud* where a trader only reports a proportion of sales, falsifying records and accounts to match, or may make some sales off the books entirely. Another kind of fraud is *retail fraud* where the trader skims off his sale figures from tax authorities by using a second till or by adding on programs, 'Zappers' to the cash registers that are programmed so it skims off part of the sale figure.⁷ Another kind is fraud connected to *failure to register* and can for example be a ghost trader or a service provider that do not account for VAT or their income to tax authorities and therefore do not pay the VAT or other taxes. This is just a few simplified examples and by no means a sufficient overview over the complexity of VAT fraud.⁸

MTIC fraud: Transactions between EU Member States do not attract VAT as they are zero-rated and that has created opportunity for fraud. MTIC fraud can be sorted into two types: *acquisition fraud* and *carousel fraud*.

Acquisition fraud is when a trader imports goods or services from another Member State without having paid VAT, sells it onwards to a domestic customer, including VAT, and then disappears without paying for the VAT collected.⁹

The best known type of tax evasion is probably *carousel fraud*¹⁰ which is one kind of MTIC. It works as follows: Trader A in Member State 1 sells goods to trader B in Member State 2. The sale is zero-rated as it is an intra-community supply. Trader B sells the goods to trader C in Member State 2 and charges VAT of the supply but does not remit, or pay, the VAT to appropriate authorities in Member State 2.¹¹ Trader B (often called the Missing Trader) embezzles the VAT by disappearing or using a hijacked VAT number.¹²

⁶ Shankar Rajagoplan, 'Reverse charging to prevent VAT fraud' (Recon LLP December 2006. <<http://www.reckon.co.uk/reckon-reverse-charging-dec2006.pdf>> accessed 3 May 2012).

⁷ Richard T. Ainsworth, 'Zappers – Retail VAT Fraud' (2010) May/June International VAT Monitor 175.

⁸ Michael Keen and Stephen Smith (2007), p. 7-8.

⁹ Shankar Rajagoplan, 'Reverse charging to prevent VAT fraud' (2006).

¹⁰ Beate Wohlfahrt, 'The Future of the European VAT System' (2011) November/December International VAT Monitor 387, p. 389.

¹¹ Redmar A Wolf, 'The Sad History of Carbon Carousels' (2010) November/December International VAT Monitor 403, p. 404.

¹² Ben Terra and Julie Kajus, *A Guide to the European VAT Directive: Introduction to European VAT 2011*, volume 1 (IBFD 2011) p. 334.

Trader C then sells the goods back to Trader A, in Member State 1, and as it is an intra-community supply that supply is zero-rated and Trader C (often called the Broker) claims a refund of the VAT from tax authorities in Member State 2 on the purchases from trader B.¹³ This kind of fraud can be much more complex, for example involving goods going through several traders (called Buffers) several Member States, and can even reach into third countries outside of the internal market of EU.¹⁴ This circular trade chain can be repeated and the main objective of the fraudsters is to create enormous turnover and collect as much VAT as they can, within a short period of time, before the fraud is discovered.¹⁵ The name carousel fraud comes from the circular movement of the goods.¹⁶

Missing trader fraud is as old as the VAT itself but it surfaced in France in 1954. There, a criminal organization collected scrap iron for free, or from private individuals and sold the iron to steel companies with VAT and the invoices were issued by tramps, who were found dead shortly after the tax authorities traced the fraud.¹⁷ The first VAT carousel fraud was discovered in the 1970s in the Netherlands under the Benelux regime.¹⁸

There is a built in protection of tax revenues in the principle of fractionated payment of VAT that does not work when the intra-Community supplies are zero-rated. The zero-rate makes carousel fraud, or missing trader fraud in intra-community, attractive for fraudster¹⁹ as they can embezzle the whole amount of VAT on the goods and it may be said that this fraud is subsidized by the Member States as they pay out VAT that will not be paid.²⁰

3. The reverse charge mechanism

3.1 Description and Articles in the RVD

When the liability to pay VAT is shifted from the supplier to the recipient of the supply it is called reverse charge. The main rule is that VAT is payable by any taxable person carrying out a taxable supply or service and it can be found in Article 193 of the RVD.²¹ Exception to this main rule can be found in the same article where the VAT is payable by another person, in cases

¹³ Commission, 'Report from the Commission to the Council and the European Parliament on the use of Administrative Cooperation Arrangements in the Fight Against VAT Fraud' COM(2004) 260 final, p. 6.

¹⁴ COM(2004) 260 final, 6.

¹⁵ Redmar A Wolf (2010), p. 404.

¹⁶ Redmar A Wolf (2010), p. 404.

¹⁷ Christian Amand and Kris Boucquez, 'A New Defence for Victims of EU Missing-Trader Fraud?' (2011) July/August International VAT Monitor 234, p. 236.

¹⁸ Redmar A Wolf (2010), p. 404.

¹⁹ Beate Wohlfahrt (2011), p. 387-389.

²⁰ Redmar A Wolf (2010), p. 407.

²¹ Ben Terra, *Introduction to VAT and the VAT of the European Union* (Series on International indirect tax University of Lund Volume 17, Cajus Media 2011) ch. 2.13.1.

referred to in Articles 194 to 199 and Article 202 of the RVD.²² An Annex appending with this thesis will reveal how reverse charge is used in those Articles.

According to the reverse charge mechanism it is the customer, which is the person to whom the good or the services are supplied to, who must pay and account for the VAT, not the supplier.²³ If the recipient, that is the customer, is a taxable person he is entitled, by Article 168(a) of the RVD, to deduct the VAT he is obliged to pay.²⁴ On the VAT return the recipient accounts for the VAT he is obliged to pay according to the reverse charge mechanism but he can also account it as an input VAT on the same VAT return and does therefor neither pay VAT nor can he claim repayment. If the recipient sells the goods or the service again he shall charge VAT from the buyer and is liable to pay and account for it as long as it is not an intra-community supply, exportation supply, or a supply with reverse charge.

Article 395 of the RVD grants the Council the authority to authorise Member States to introduce special derogation from Article 193 of the RVD in order to simplify the procedure for collecting VAT or to prevent certain forms of tax evasions or avoidances. The Member States may apply for special derogation and if the Commission agrees that the applications fulfil requirements for such derogation the Commission makes a proposal for the Council decide whether or not the proposal is approved. If Member States want to introduce a reverse charge on other supplies than are mentioned in Article 199 and 199a of the RVD, they need approval from the Council for that derogation from Article 193 according to Article 395 of the RVD.

Articles 194, 195, 196 and 197 of the RVD are all about circumstances where the supplier of the goods or service is not established in a Member State and the provision deems to give the Member States the right to choose whether to use reverse charge in those circumstances. Using reverse charge when the supplier is not established in the Member States makes collection of VAT run more smoothly as it can be difficult to track down a taxable person who is not established in the country. The use of reverse charge in those situations removes the temptation for non-established taxable persons to sit back without paying the VAT. Many Member States use general reverse charge for non-established taxable persons, for example. Italy, Spain, and Netherlands.

²² Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (the Recast VAT Directive) OJ L 347, 11.12.2006 p. 1.

²³ Aleksandra Bal, 'VAT Treatment of Transaction in the German Construction Sector' (2011) November/December International VAT Monitor 404, p. 407.

²⁴ Ben Terra, *Introduction to VAT and the VAT of the European Union* (2011) ch. 2.12.1.

The reverse charge mechanism in Article 198 of the RVD is a part of a special scheme²⁵ for gold investment. The aim of the article is to prevent tax fraud.²⁶

Member States have the option to introduce a reverse charge mechanism provided in Article 199 and 199a of the RVD. Article 199 is based on a European Commission Proposal²⁷ where a certain measure to simplify the procedure for charging VAT and to assist in countering tax evasion and avoidance was adopted into the Sixth Directive with the Directive 2006/69/EC.^{28 29} In the Explanatory Memorandum with this proposal is stated that the supplies that are made optional for reverse charge are sectors of the economy which have proved particularly difficult for the Member State to police, for example due to the nature of the industry or its structure. There is also a chapter with the headline “Reverse Charge” and a though tax fraud or evasion is not mentioned in that chapter it is stated that often “*substantial revenue losses arise from taxable person invoicing for supplies prior to disappearing without accounting for the VAT on the invoice, whilst at the same time the recipient legitimately exercises his right to deduct.*”³⁰ Ben Terra, in *Introduction to VAT and the VAT of the European Union*,³¹ states that the Explanatory Memorandum presumably, but not necessarily correctly, refers to tax evasion and with the quotation above in mind that looks like logical conclusion. The same chapter of the Explanatory Memorandum states that the effect of the reverse charge both simplifies the system and makes it more efficient, without having an impact in tax terms on the customer, and with minimal compliance cost.³²

The Commission presented a proposal for a Council Directive to amend the RVD, on 29 September 2009, as regarding an optional and temporary application of the reverse charge mechanism in relation to supplies of certain goods and services susceptible to fraud.³³ The Council adopted Directive

²⁵ Council Directive 98/80/EC of 12 October 1998 supplementing the common system of value added tax and amending Directive 77/388/EEC - Special scheme for investment gold *OJ L 281 , 17/10/1998 p. 0031 – 0034.*

²⁶ Ben J M Terra, ‘New VAT Rules on Investment Gold’ (1999) January/February VAT Monitor 16, p. 21.

²⁷ Commission, ‘Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations’ COM(2005) 89 final and 2005/0019 (CNS).

²⁸ Article 1(7), Council Directive 2006/69/EC of 24 July 2006 amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion or avoidance, and repealing certain Decisions granting derogations *OJ L 221 11.8.2006, p. 9.*

²⁹ Ben Terra, *Introduction to VAT and the VAT of the European Union* (2011) ch. 2.12.1.

³⁰ COM(2005) 89, p 7.

³¹ Ben Terra, *Introduction to VAT and the VAT of the European Union* (2011) ch. 2.12.1.

³² COM(2005) 89, p. 8.

³³ COM(2009) 511 final and 2009/0139 (CNS).

2010/23/EU,³⁴ on 16 March 2010, which inserted Article 199a into the RVD and allowed Member States to apply the reverse charge mechanism on transfer of greenhouse gas emission allowances. On other elements of the proposal, that is the reverse charge for supply of mobile phones and electronic circuit devices, the Council agreed to continue to work on it with the goal of reaching an agreement as soon as possible.³⁵

In Explanatory Memorandum with above proposal from the Commission from 29 September 2009 states the purpose of it “*is to allow temporary application of reverse charge mechanism to combat existing fraud in relation to transaction involving certain fraud-sensitive goods.*”³⁶ There it is also stated that exertion of reverse charge mechanism should be restricted to a pre-defined list of goods and services so that the fundamental principle of VAT as a fractionated payment would not be altered.

3.2 The reverse charge mechanism to fight VAT fraud

As has been mentioned, frauds are major concerns for the Member States as they are a threat to tax revenues and a correct function of the Internal Market. To combat fraud schemes some Member States have been granted derogation by the Council on the base of Article 395 of the RVD to use reverse charge mechanism on particular fraud sensitive sector or on certain goods. As some of the special measures had proven successful in the fight against VAT avoidance and evasion, they were provided in Article 199 and 199a of the RVD in sectors that are considered sensitive to VAT fraud. Member States can therefore introduce reverse charge based on those provisions without having to seek individual authorisation for it.³⁷ The most common form of evasion in this context is missing trader fraud, where the taxable person that is liable for the VAT does not pay the VAT but gives out a valid invoice to his customer. The result is then not only that Member State does not receive the VAT on the supply but must give the next trader in the chain credit for input VAT. This is a sort of MTIC fraud that can be organised to be reduplicated or as a carousel fraud so Member States may lose several times the amount of the VAT on a single amount of goods.³⁸

³⁴ Council Directive 2010/23/EU of 16 March 2010 amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain services susceptible to fraud *OJ L 72 20.3.2010, p. 1.*

³⁵ Ben Terra, *Introduction to VAT and the VAT of the European Union* (2011) ch. 2.13.1; Council, ‘Council approve measure to clamp down on fraud in CO2 emission allowance trading’ 6945/10 (Presse 46).

³⁶ COM(2009) 511 final, p. 2.

³⁷ Commission, ‘Accompanying document to the Green Paper on the future of VAT Towards a simpler, more robust and efficient VAT system’ (Commission Staff Working Document) SEC(2010) 1455, p. 60.

³⁸ COM(2009) 511 final, p. 3.

In the reverse charge mechanism no VAT is charged by the supplier to taxable customers. The taxable customer becomes liable for the payment of the VAT but can deduct input VAT instead so he does not pay VAT if he supplies the goods or the service to another taxable person. In this mechanism nobody gets credit for input VAT without being liable for payment of VAT from the supply. So in this sense, the theoretical possibility to commit fraud is removed and there are no VAT credits that Member States lose revenue on, that is as input VAT or repayment of VAT.³⁹

The Member States have used reverse charge mechanism to fight VAT and as an example a general reverse charge mechanism was introduced in Belgium back in 1977 within the construction sector.⁴⁰ This was a sector where tax authorities were confronted with substantial tax evasion but under the reverse charge mechanism prevented main contractors from deducting the VAT that had never been paid by the subcontractors.⁴¹

When the Member States set up reverse charge system for a certain sector, for example the mobile phones, the trade chain can look like this:

A reverse charge system⁴²

Company A

1. Purchases mobile phones from another Member State.
No VAT on intra-community supply.
2. Sells the mobile phones to Company B.
Reverses charge = no VAT charged
3. Submits information about the sale to tax authorities.



Company B

1. Purchases mobile phones from Company A.
Reverses charge = No VAT paid but Company B is liable for the VAT.
2. Sells the mobile phones to Company C.
Reverses charge = no VAT charged.
3. Submits information about the purchase and the sale to tax authorities.

³⁹ COM(2009) 511 final, p. 3.

⁴⁰ The so-called “sub-contractor arrangement” see Ivan Massin, ‘Introduction of a General Anti-VAT Avoidance Measure in Belgium’ (2006) January/February International VAT Monitor 37, p. 38.

⁴¹ Ivan Massin (2006), p. 38.

⁴² House of Lords, ‘Stopping the Carousel: Missing Trader Fraud in EU: Report with Evidence’ (European Union Committee 20th Report of Session 2006-07, House of Lords 2007 <<http://www.publications.parliament.uk/pa/ld200607/ldselect/ldcom/101/101.pdf>> accessed 25 April 2012, p. 19.



Company C

1. Purchases mobile phones from Company B.
Reverses charge = No VAT paid but Company C is liable for the VAT.
2. Sells the mobile phones to consumer.
VAT charged on the sale.
3. Submits payment of the VAT and information about the purchase and the sale to tax authorities.

3.3 Advantage and shortcoming of the reverse charge mechanism

The primary advantage of the reverse charge mechanism is when it is applied it makes MTIC and carousel fraud impossible at all stages in the supply chain, except at the retail level.⁴³ As there is no VAT charged and no VAT paid there is no VAT to be embezzled and there is no VAT claim left behind that can create revenue loss because of refund of input VAT that has not been paid.⁴⁴

Member States have been applying reverse charge because they have had positive experiences using it. At least, a positive experience from the construction sector was the reason that Austria stated in the request to introduce a reverse charge 2005. Austria's request for a reverse charge was in respect of all Business to Business supplies of goods or services where the invoice value exceeds €10,000, and where the supplies to customer exceed €40,000 in the accounting period. Germany, likewise requested to introduce a reverse charge in respect of all Business to Business supplies of goods or services where the invoice value exceeded €5,000 with similar reasoning as Austria.⁴⁵ The commission considered these request from Austria and Germany too general and widespread, so they could not be authorised as derogating from Article 193 of the RVD.⁴⁶ Their application also failed the test, required by Article 395 of the RVD,⁴⁷ insofar as they would make life more complicated, rather than simpler both for taxable persons and tax administration in addition onto providing more, rather than less scope for tax evasion.⁴⁸

To deal with MTIC fraud, the UK requested and was authorised to apply a reverse charge mechanism at a set threshold of £5,000 on a limited number of products such as mobile phones, integrated circuit devices, and more. These

⁴³ Shankar Rajagopalan, (2006).

⁴⁴ Shankar Rajagopalan. (2006).

⁴⁵ Commission, 'Communication from the Commission to the Council in accordance with Article 27(3) of Directive 77/388/EEC' COM(2006) 404 final.

⁴⁶ On that time it was Article 21 of the Sixth Directive.

⁴⁷ On that time it was Article 27 of the Sixth Directive.

⁴⁸ COM(2006) 404 final, p. 6.

products had given rise to a very high level of tax evasion in the UK according to the application and the attempt was to remove possibilities for potential missing trader fraud as no VAT would be charged.⁴⁹

In the request from Austria two interesting points used as support for the application. First is that reverse charge will reduce the burden on tax administration which would otherwise have to pursue the tax due by defaulting taxable persons or carry out inspection before granting VAT refunds. Second is that taxable person does not have to pre finance the VAT in reverse charge system and that would be beneficial for them.⁵⁰

To what extent the reverse charge mechanism was an appropriate and efficient instrument to tackle fraud-specific sectors has not yet been possible to determine.⁵¹ When the UK was authorized, by Council Decision 2007/250/EC,⁵² to apply the above mentioned reverse charge it was a requirement that a report should be submitted to the Commission on the overall evaluation of the operation of the measure and any evidence of the shifting of the tax evasion to other products or to the retail level. That report has not been submitted and, despite that, the UK permission was extended until 30 April 2011 with Council Decision 2009/439/EC⁵³ and 31 December 2014 with Council Decision 2010/710/EU.⁵⁴ It is a little bit strange that there should not be more research into what effect this method has had on the VAT system and what effect it have on VAT fraud and instead it seems that the Commission and the Council rely on statements from Member States about positive experiences from using the reverse charge mechanism.

It sometimes seems like it is easier to comment on shortcomings and flaws than on the advantages and what is well-handled, as can be seen from the

⁴⁹ Commission, 'Proposal for a Council Decision authorising the United Kingdom to introduce a special measure derogating from Article 21(1)(a) of Directive 77/388/EEC on the harmonisation of the laws of the Member States relating to turnover taxes' COM(2006) 555 final p. 2-3; Commission, 'Proposal for a amending Council Decision 2007/250/EC authorising the United Kingdom to introduce a special measure derogating from Article 193 of Directive 2006/112/EC on the common system of value added tax' COM(2009) 183 final p. 2-3.

⁵⁰ COM(2006) 404 final, p. 3.

⁵¹ COM(2009) 511 final, p. 3.

⁵² Council Decision 2007/250/EC of 16 April 2007 authorising the United Kingdom to introduce a special measure derogating from Article 193 of Directive 2006/112/EC on the common system of value added tax *OJ L109 6.4.2007, p. 42.*

⁵³ Council Decision 2009/439/EC of 5 May 2009 amending Decision 2007/250/EC authorising the United Kingdom to introduce a special measure derogating from Article 193 of Directive 2006/112/EC on the common system of value added tax *OJ L 148 11.6.2009, p. 4.*

⁵⁴ Council Implementing Decision 2010/710/EU of 22 November 2010 authorising Germany, Italy and Austria to introduce a special measure derogating from Article 193 of Directive 2006/112/EC and amending Decision 2007/250/EC to extend the period of validity of the authorisation granted to the United Kingdom *OC L309 25.11.2010, p 5.*

number of shortcomings that have been dedicated to the reverse charge mechanism.

Reverse charge significantly shifts away from the principle of fractioned payment of VAT whereby each taxable person (with a right of deduction) in the chain pays a part of the total VAT amount to the State Treasury amounting to the difference between the VAT amount received from the client and the VAT amount paid to his supplier.⁵⁵

The potential for fraud still exist at the retail level in systems with reverse charge and the amount of the tax that can be defrauded is greater because of the breach of the principle of fractioned payment and therefore making fraud at the retail level potentially more lucrative.⁵⁶

When the reverse charge mechanism only applies to a limited range of products, the carousel fraudsters are still able to carry out their activities by trading in other products.⁵⁷ With the introduction of a more generalized reverse charge mechanism it could be expected that new forms and patterns of fraud would occur.⁵⁸ That new ways or tactics to commit a fraud develop is not something that just happens where the reverse charge mechanism is used as it is likely that it follow every method that is used to fight fraud. It seems that new ways to cheat and deceive will always be found.

The reverse charge mechanism is not a solution to “*black sales*” (that is off the record sales) which remain outside the official circuit. The Committee states in COM(2006) 404 final:

For a taxable person, who has to charge VAT at the end of the supply chain, the incentive to obtain “black” supplies will increase as he has to account for the total amount of the VAT and no longer just for the fractionated part in relation to his “value added”⁵⁹

A large portion of the VAT collected by each Member State is currently paid by a very small group of big, compliant taxable persons. Applying a generalized reverse charge would mean that the tax would be collected from a much larger group of taxpayers, making control proportionally more difficult.⁶⁰

⁵⁵ Shankar Rajagopalan (2006); COM(2009) 183 final, p. 2.

⁵⁶ Shankar Rajagopalan (2006).

⁵⁷ Shankar Rajagopalan (2006); Richard T Ainsworth, ‘MTIC (VAT fraud) in VoIP – Market Size: \$3.3B’ (Boston University School of Law Working Paper No. 10-03, February 2010 <<http://www.bu.edu/law/faculty/scholarship/workingpapers/documents/AinsworthR111210.pdf>> accessed 20 April 2012), p. 25.

⁵⁸ COM(2006) 404 final, p. 4.

⁵⁹ COM(2006) 404 final, p. 4.

⁶⁰ COM(2006) 404 final, p. 5.

In addition, a reverse charge system considerably weakens the control towards the end of the distribution chain. Consequently, tax administrations would have to significantly increase the number of control officials to deal with the greater risk arising from the tax debt being spread over a larger number of taxable persons.⁶¹

The reverse charge would probably add an extra layer of difficulty to the accounting burdens already faced by businesses. Similarly, additional compliance burdens (verifying the nature of customers and reporting transactions) would be imposed on honest traders operating in areas where fraud is not prevalent.⁶²

Furthermore, under the reverse charge system, the financial risk of the VAT payment, VAT is transferred from the Member States to businesses as it is the taxable persons that have to decide whether or not to charge VAT based on the national legislation of the Member State and on whether the customer fulfills the requirement to fall under reverse charge, for example validating the status of their customer as a genuine taxable person. Such shift of responsibility from the tax administration to businesses with potential costs for business runs counter to the Lisbon objectives.⁶³

The Commission stated in COM(2006) 404 final that the previous proposals from the Commission to the Council have been applied to specific sector (construction, waste, wood, etc.), and the reverse charge always went up the supply chain (thus only eliminating the weak level at the beginning of the chain) so that more risky small and ephemeral businesses did not charge VAT, but this was accounted to the larger, easier to control businesses.⁶⁴

Thus, a domestic reverse charge does not solve MTIC. Applied on a single supply, it prevents the spread of MITC in that supply, but it is not a scalable solution. It cannot be applied broadly, unless it is acceptable for the VAT to devolve into a retail sales tax.⁶⁵

There are over forty discrete commercial markets afflicted by MTIC today. Some are in goods; others are in services or intangibles. Many of them are far more damaging than the five “*fraud sensitive goods or services*” recently selected by the Commission as targets for specialized enforcement measures in COM(2009) 511 final.⁶⁶

⁶¹ COM(2006) 404 final, p. 7.

⁶² COM(2006) 404 final, p. 6.

⁶³ COM(2006) 404 final, p. 7.

⁶⁴ COM(2006) 404 final, p. 6.

⁶⁵ Richard T Ainsworth (2010), p. 26.

⁶⁶ Richard T Ainsworth (2010), p. 2.

If the solution is to apply a domestic reverse charge in all of the areas, which are most susceptible to missing trader fraud, it would be departing from the fractionated payment principle of the EU VAT system. That could lead to increased risk of VAT fraud in retail sales and would be similar to a sale tax system. *“Zero-rating an intermediate supply temporarily brakes the chain of fractionated payments.”*⁶⁷

It seems like the resolution is that reverse charge can be a big help in the combat against VAT fraud and especially against MTIC fraud, carousel fraud. It should be used in selected sectors which are the most sensitive for that kind of frauds. It is better to apply reverse charge on sector that the retailers are few and big rather than many and small. Here should the characteristic of the product also count as if the customer is buying a product, that he wants to have a good service for, he will look for a steadfast and dependable retailer rather than some unknown one. For example, consumers buying computers, cars or repairs on apartments think about whether the seller or service provider can fulfill the agreement and enclosed warranty. These products should therefore work well with a reverse charge. On the other hand if the product does not depend much on further service from the retailer it is more likely that reverse charge does not work as well. A widespread and general reverse charge system is a bigger threat to the principles of the VAT as the principle of proportionality and principle of fractionated payment as it could also affect transaction in all economic sectors the system spans including sectors which never have been suspected of being subject to MTIC or carousel fraud.⁶⁸

It is against this background, and after having demonstrated the historical seriousness of the problem in the UK, that a derogation was granted to apply a reverse charge procedure at a set threshold of £5,000 and for a limited number of products, which are the most subject to fraud, in an attempt to remove fraud possibilities for potential missing traders as no VAT would be charged.⁶⁹

3.4 A general reverse charge system

The Commission examined two more “far-reaching” measures to tackle VAT fraud and published its analysis and results of that analysis in Communication on measures to change the VAT system to fight fraud, COM(2008) 109 final, and in Commission staff working paper on the same subject, SEC(2008) 249.⁷⁰ Those measures were firstly taxation of intra-Community supplies in the Member State of departure and secondly a general reverse system.

⁶⁷ Richard T Ainsworth (2010), p. 26.

⁶⁸ COM(2006) 404 final, p. 6.

⁶⁹ COM(2009) 183 final, p. 3.

⁷⁰ Commission, ‘Communication from the Commission to the Council and the European Parliament on measures to change the VAT system to fight fraud’ COM(2008) 109 final; Commission, ‘Commission staff working paper on measures to change the VAT system to fight fraud’ SEC(2008)249.

The idea for a general reverse system was that reverse charge should be applied to all Business to Business supplies with a threshold of €5,000 for each transaction. In such system a taxable person will have to verify the status of his customer in all his domestic supplies. If the customer does not qualify for the use of the reverse charge the supplier will have to charge VAT to his customer. Mainly private persons, non-taxable legal person and fully exempt taxable persons do not qualify for the use of the reverse charge. The taxable amount of the supply must also be equal or above €5,000 to fall under the reverse charge and if it does not the supplier must charge VAT to his customer. The introduction of a generalised reverse charge system would only affect the rules for taxation a domestic supplies of good and services. The rules for taxation of intra-Community transaction or transaction with third countries should not be affected from it.⁷¹

In the analysis of a general reverse charge system is mainly split up in four parts:

1. Risk of new forms of fraud resulting from the use of a reverse system on an optional basis.
2. Cost for the taxpayers and administrations.
3. Effect of a generalised reverse charge system on other Member States.
4. Coherence and harmonisation of VAT law in the EU.

As results of the Commission analysis the Commission believes that the introduction of a generalised reverse charge would substantially reduce MTIC fraud as well as other types of deduction fraud. However are the Commission concerned that such system may end up having negative effects on Member States revenues because of other new types of fraud. This system would impose new responsibilities for business e.g. the system would be based on making a distinction between taxable persons qualifying for the reverse charge system and all other persons. Additional cost for trader will inevitably follow such general reverse system.⁷²

Responses from Member States about the potential effects of applying a reverse charge system on other Member States were that it was deemed necessary to operate a very tough control system in order to protect other Member States from adverse effects that the reverse charge could potentially create. To cope with such a new situation improvement is judged to be needed on administrative cooperation.⁷³

It is the view of the Commission that introducing a generalised reverse charge on an optional basis would be such a fundamental change to the VAT system which has significant effect on the coherence and harmonisation of the EU

⁷¹ SEC(2008) 249

⁷² COM(2008) 109 final, p. 7-10; SEC(2008) 249, p. 26, 29, 32-33,

⁷³ COM(2008) 109 final, p. 9.

VAT system and the scope for its future development. It would be like the European Community had two fundamentally different VAT systems. The conclusion of the Commission was that a general reverse charge system should either be introduced on mandatory basis throughout the EU or be disregarded as a concept.⁷⁴

4. Joint and several liability

4.1 Description, Articles 205 of the RVD and EJC cases

Another way to combat VAT fraud is to hold a third party liable for the tax lost. Article 205 of the RVD allows Member States to arrange for someone other than the taxable person that is liable for the VAT payment to also be held jointly and severally liable for that same payment,⁷⁵ or as the provision says:

Article 205

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.

This provision is optional and has been applied under various conditions in Member States.⁷⁶ It can be practical to apply this provision in a context of missing trader fraud, whereby a number of actors intervene with the only objective of hiding the fraudulent character of the transaction chain and thereby making the detection more complicated.⁷⁷

In a report from the Commission to the Council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud from 16 April 2004 it stated that some Member States had then recently changed their anti-fraud legislation by introducing a fiscal joint and several liability. It was stated that introducing such a liability implies that if a taxable person knows or should have known of the fraudulent activities of his co-contractor, he would be liable, with joint and several liability, to pay the VAT that his co-contractor was liable to pay. The legal base for this measure was in Article 21 of the Sixth Directive⁷⁸ with the condition that the principle

⁷⁴ COM(2008) 109 final, p. 9-10.

⁷⁵ Ben J M Terra and Peter J Wattel *European TAX Law* (Abridge student edition Fifth edition, Kluwer Law International 2008), p. 188.

⁷⁶ Joint and several liability is applied in following Member States: Austria, Belgium, Bulgaria, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Romania, the Slovak Republic, Slovenia, Spain and the UK according to EU VAT Compass 2009/2010; Ine Lejune, Silvia Kotanidis and Ellen Cortvriend, 'Joint and Several Liability relating to Intra-Community Acquisitions, (2009) September/October International VAT Monitor 362, p. 365.

⁷⁷ Commission, 'Communication from the Commission to the Council concerning some key elements contributing to the establishment of the VAT anti-fraud strategy within the EU' COM(2007) 758 final, p. 11.

⁷⁸ Now Article 205 of the RVD.

of proportionality was respected. The report claimed that in some Member States the introduction of this kind of joint and several liability had a clear deterrent effect and seem to be effective.⁷⁹

The UK was one of those Member State and in the year 2003 a new provision was enacted in the Value Added Tax Act from 1994 (the VAT Act). With these new provisions in the VAT Act, joint and several liability was established in a supply chains, involving telecommunication or computer related products, where “*a taxable person knew or had reasonable grounds to suspect that some or all of the VAT payable in respect of that supply, or on any previous or subsequent supply of those goods, would go unpaid.*”⁸⁰ This was done with the purpose of fighting against missing trader fraud as well as carousel fraud and the changes were legislated with section 17 and 18 of the Finance Act 2003.⁸¹

The EJC case C-384/04 Federation of Technological Industries.⁸²

The beginning of that case was when the Federation of Technological Industries (Federation) requested for judicial review of those provisions with the joint and several liability, arguing that they were unauthorized by Community law. This case went first in front of the High Court of Justice and it was then appealed to the Court of Appeal which requested a preliminary ruling from the ECJ. Authorities in the UK held that the power to enact section 17 and 18 came from Articles 21(3) and 22(8) of the Sixth Directive but the Federation rejected that argument and claimed that the section was authorized neither by Article 21(3) nor by Article 22(8).

The changes to the VAT Act which came with section 17 allowed authorities to require taxable persons or another relevant person to give security for the payment of any VAT. There is no need for further discussion about this part of the case in this thesis.

The changes to the VAT Act that came with section 18 of the Finance Act 2003, which became section 77A of the VAT Act, established joint and several liability in a supply chain where taxes are left unpaid. Taxable persons trading with telecommunication or computer related products could become joint and severally liable for the VAT. The condition was that at the time of the supply, the person knew or had reasonable grounds to suspect that some or all of the VAT payable in respect of that supply, or on any previous or subsequent supply of those goods, would go unpaid. In subsection 6, 7, and 8

⁷⁹ COM(2004) 260 final, p. 15.

⁸⁰ From Section 77A of the VAT Act 1994 in UK, see ECJ Case C-384/04 *Commissioners of Customs & Excise v. Federation of Technological Industries and Others* 2006 ECR I-04191 (the FTI Case), para 6.

⁸¹ Colin Woodward, ‘The New UK Approach to Carousel Fraud’ (2006) July/August International VAT Monitor 240; The FTI Case.

⁸² ECJ Case C-384/04 *Commissioners of Customs & Excise v. Federation of Technological Industries and Others* 2006 ECR I-04191 (the above mentioned FTI Case).

of section 77A of the VAT Act were provisions about presumptions on when a taxable person had reasonable grounds for suspecting that the VAT would go unpaid.

Article 21(3) of the Sixth Directives was as follows:⁸³

In the situations referred to in paragraphs 1 and 2, Member States may provide that someone other than the person liable for payment of the tax shall be held jointly and severally liable for payment of the tax.

The essence of the first and the third questions that were referred to the Court was whether interpretation of Article 21(3) of the Sixth Directive allowed Member States to legislate rules, like this provision in the UK VAT Act, which led to that taxable person may be made jointly and severally liable for payment of VAT because they know, or had reasonable grounds to suspect, that some or all of the VAT of any previous or subsequent supply, would go unpaid.⁸⁴

The Federation argued that Article 21(3) of the Sixth Directive only allowed Member States to legislate provisions that permit persons to be made jointly and severally liable for VAT payments in four situations that are referred to in the Article. The UK maintained that liability was possible in all situations that were in Article 21(1) and (2) of the Sixth Directive.

The Courts finding was that Article 21(3) of the Sixth Directive allowed Member States to make a person jointly and severally liable for VAT in all situation that Article 21(1) and (2) grant liability for.⁸⁵ The Member States must though “*comply with the general principles of law which form part of the Community legal order, which include, in particular, the principles of legal certainty and proportionality*”.⁸⁶

Concerning the principle of proportionality the Court pointed out that though it is permissible for the Member States on the ground of Article 21(3) of the Sixth Directive to pursue methods to maintain the tax base of the states treasury as successfully as possible, it may not be done in a way that it goes further than what is needed for that intention.⁸⁷

Article 21(3)⁸⁸ of the sixth Directive allows Member States to make person jointly and severally liable for the payment of VAT as is done in the UK VAT provision in question and it can rely on presumptions in that regards.

⁸³ Article 21(3) of the Sixth Directive is now Article 205 of the RVD.

⁸⁴ The FTI Case, para 18.

⁸⁵ The FTI Case, para 25 and 27.

⁸⁶ The FTI Case, para 28.

⁸⁷ The FTI Case, para 30.

⁸⁸ Is substantially the same as Article 205 in the RVD is now.

However, the Court placed emphasis on that such presumptions may not be framed in a way that it makes it almost impossible or extremely difficult to disprove with evidence to the contrary.⁸⁹ In fact it would lead to strict liability if those presumptions would go beyond what is necessary to preserve the rights of the state treasury as Advocate General Poiares Maduro⁹⁰ points out in his opinion.⁹¹

In direct connection with this the Court makes this statement:

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.⁹²

Attention is called on that it is for the national court to determine whether legislation in issue complies with the general principle of community law.

On this ground the Court ruling was as follows:

Article 21(3) of Sixth Council Directive [...] is to be interpreted as allowing a Member State to enact legislation, such as that in issue in the main proceedings, which provides that a taxable person, to whom a supply of goods or services has been made and who knew, or had reasonable grounds to suspect, that some or all of the value added tax payable in respect of that supply, or of any previous or subsequent supply, would go unpaid, may be made jointly and severally liable, with the person who is liable, for payment of that tax. Such legislation must, however, comply with the general principles of law which form part of the Community legal order and which include, in particular, the principles of legal certainty and proportionality.⁹³

In Commission Staff working document SEC(2010) 1455, accompanying document to the GREEN PAPER on the future of VAT is said that for each intra-EU supply, the supplier has to keep additional and specific records and count them up. It is then stated that such details are needed not only to justify the VAT treatment of the transaction but also to avoid the supplier being subsequently held jointly and severally liable if the customer liable for that

⁸⁹ The FTI Case, para 32.

⁹⁰ Case C-384/04 Commissioners of Customs & Excise v. Federation of Technological Industries and Others 2006 ECR I-04191, Opinion of AG, Poiares Maduro, para 27, 28-31.

⁹¹ The FTI Case, para 32.

⁹² The FTI Case, para 33.

⁹³ The second and fourth question does not matter for the subject of this thesis but they are whether Article 22(8) of the Sixth Directive allows legislation as in the case. The Court ruled that it did not allow it. Question five was unnecessary to answer according to the Court.

payment of VAT does not pay it. The statement continue and says that the tax administration must prove that he knew or should have known that the customer would not pay the VAT to hold the supplier jointly and severally liable. To support this there is referred to the so-called 'knowledge test' and C-384/03 FTI.⁹⁴ This kind of rule cannot be found in the FTI case and the judgement in the case only says that Member State may enact such legislation which lay joint and several liability on taxable person that know or had reasonable ground to suspect that some or all of the VAT would go unpaid. Without such domestic legislation person cannot be held jointly and severally liable even if he know or should have known about fraud. It cannot either been seen that the knowledge test can hold supplier jointly and severally liable as it take only to refusal of the right to deduct VAT or use the exemption for zero-rate as will be cover better in chapter 6.

Case C-499/10 Vlaamse Oliemaatschappij NV (VOM).⁹⁵

VOM is a service provider in Belgium which unloads stores in warehouses and transfers onto trucks petroleum product that arrive to him by boat for his customer. The customers store the goods in those warehouses until they are sold to the final customer. For those services VOM gets service fee which depends on the number of litres handled. VOM therefore operates a "tax warehouse" within the meaning of Article 4(b) of Directive 92/12.⁹⁶ One of VOM customers, Ghebra, was a fuel wholesaler that stored products in VOM's warehouse and it was declared insolvent in June 2003. According to tax audit report from the tax authorities dated 7 February 2006 fuel had been supplied for valuable consideration and released from VOM's warehouse by Ghebra during March and April 2003. Based on a national prevision, Article 51a(3) of the Belgian VAT Code, the warehouse keeper, the person responsible for the transport of the goods from the warehouse and his principal are held joint and severally liable for the payment of the VAT of the goods. By referring to this liability provision the Belgian tax authorities issued an order for recovery against VOM for the amount of the VAT owed by Ghebra. VOM contested this decision on the grounds that it would be contrary to the principle of legal certainty and proportionality to hold warehouse keeper jointly and severally liable for VAT owed by the warehouse user if the warehouse keeper acted in good faith. The Belgian authorities claimed that the Article 51a(3) in compliance with the principle of proportionality. The case went to the ECJ were the Court said that the joint and several obligation in the Belgian VAT code is worded unconditionally with the result that it applies to warehouse keeper even where he acts in good faith or no fault or negligence can be imputed to him. The Court said it would

⁹⁴ SEC(2010) 1455, p. 12.

⁹⁵ ECJ Case C-499/10 *Vlaamse Oliemaatschappij NV v. FOD Financiën* OJ C49 18.2.2012, p. 18.

⁹⁶ Council Directive 92/12/EEC of 25 February 1992 on the general arrangements for products subject to excise duty and on the holding, movement and monitoring of such products OJ L076, 23.03.1992 p. 1.

clearly be disproportionate to hold person unconditionally liable for the shortfall in tax caused by acts of a third party over which he has no influence whatsoever. The outcome of the ruling was that the joint and several liability provision in the VAT Directive⁹⁷ must be interpreted on that way that it does not authorise Member State to make warehouse keeper jointly and severally liable for VAT the owner of the goods is liable to pay when the warehouse keeper acts in good faith or where no fault or negligence can be imputed to him.

It also stated in this case that is not contrary to EU law to require persons to take every step which could reasonably be required of them to satisfy to themselves that the transactions which they are effecting do not result in their participation in tax evasion.

4.2 Advantage and shortcoming of the joint and several liability

Implementing joint and several liability is certainly a simple way and should be set up with clear rules so they are in line with the principles of legal certainty and transparency. The case law shows that such the national rules need to comply with general principles of law which form part of the Community legal order, in particular, the principles of legal certainty and proportionality. With proportionality in mind the rules may not be so they do not go further than what is necessary to reach the aim that the rules intend.

Advocate General, Poiares Maduro, says in his Opinion in the cases C-354/03 (Optigen case)⁹⁸, when he is dealing with appropriate measures against carousel fraud, he point on Article 21 of the Sixth Directive (now Article 205 of the RVD) that Member State can use to introduce joint and several fiscal liability and that a taxable person can accordingly be held accountable for the payment of VAT due by his co-contractor, if he knew or should have known of his co-contractor's fraudulent activities. Those kinds of measures have been adopted against carousel fraud in several Member States.

If joint and several liability is taken up to combat VAT fraud it is natural that the rules have some kind of condition when the liability shall apply. As is said here above the condition must be in harmony with legal principles and the EU VAT system. Usually the liability is for taxable persons that know or should have known about fraud in a supply chain they are part of or something like that. If the conditions are set up so that innocent traders can become liable, the rules can create problems than they were set out to solve. Here must look to the Case law that say that rule that make person liable when he is in good faith or no fault or negligence can be imputed to him are in breach with the

⁹⁷ The provision was then in Article 21(3) of the Sixth Directive but is now in Article 205 of the RVD.

⁹⁸ Joined Cases C-354/03 *Optigen Ltd*, C-355/03 *Fulcrum Electronics Ltd* and C-484/03 *Bond House Systems Ltd v. Commissioners of Customs & Excise* 2006 ECR I-00483

right interpretation of Article 205 of the RVD as can be seen from the WOM case.

What shortcomings can occur depends often on the conditions that are for the liability. When a taxable person can be held jointly and severally liable for payment of VAT because he knew or should have known about fraud, the same problems arise in interpretation of this concept as rise in connection with the knowledge test. The ECJ Court have said that is up to the national courts to interpreted concept the knowledge test and it follow certain uncertainty that follow that. Advantage and shortcoming regarding knowledge test can be the same or similar to the interpretation of concept that are put forward in liability rules according to Article 205 and that will be also be covered in chapter 5.2

According to instruction in section 77A of the VAT Act in the UK a person was presumed to have reasonable grounds for suspecting fraud if the price payable by that person was less than the lowest price that might reasonably be expected to be payable for those goods on the market, or was less than the price payable on any previous supply of those goods. That presumption is rebuttable with proof that the low price payable for the goods was attributable to circumstances unrelated with failure to pay VAT.⁹⁹ This type of presumption can be a deterrent for trading. The situations where just by buying goods on attractive prices, a taxable person can become liable for payment of VAT that went missing on account of fraud committed by others in the chain of transactions cannot be viewed as normal business risks and go against common business sense.¹⁰⁰

It is an advantage that by implementing rules according to Article 205 for person to be held jointly and severally liable because then a Member State can adopt a clear rules and condition how the rule work. It can minimise the uncertainty for taxable person about how to act to show an enough diligence. That's kind of rules must be in harmony with the EU and the VAT principles and may not hinder trade on the internal market. However, it is a non-uniform way for EU that each of the 27 Member State adopted their own rules for joint and several liability and differences in the rules between the Member States increases the administer burden for taxable persons in intra-community trades. Therefore it raises a question whether it could make more harmony if EU would put forward in-depth rules about these matters.

4.3 Proposal for EU-wide joint and several liability rules¹⁰¹

⁹⁹ The FTI case; Subsection 6, Section 77A of the UK VAT Act 1994.

¹⁰⁰ Christian Amand and Kris Boucquez, 'A New Defence for Victims of EU Missing-Trader Fraud?' (2011), p. 235.

¹⁰¹ The name "EU-wide joint and several liability rules" is idea from Businesseurope position paper from 17 March 2009.

The Commission has for several years been discussing and working on a strategy to improve the VAT system, or on measures to change it so it will be more effective in fighting VAT fraud, in that regard joint and several liability have often been mentioned as solution. One way that the Commission mentions is that Article 205 of the RVD already provides a base for the Member States to introduce rules that make persons that know or should have known of fraudulent activities liable for the VAT with joint and several liability.¹⁰² Another way that is discussed is the possibility of applying joint and several liability where the information on intra-Community supplies is not properly reported.¹⁰³

Following these discussions the Commission adopted a proposal for Council Directive to amend the RVD in regards to tax evasion linked to import and other cross-border transactions on 1st December 2008.¹⁰⁴ It was a part of set a of conventional measures that was presented in the context of a coordinated approach at EU level in the fight against VAT fraud. The proposal contained two amendments to the RVD. The first part was a measure to clarify the condition for a certain exemption from VAT on the intra-Community acquisition of goods. The second part was a measure to impose an obligatory joint and several liability with specific conditions. It is supposed to work in a way that where non-established taxable person carry out an exempt intra-Community supply of goods and where they do not, or not timely, fulfil their reporting obligations they will be held liable, with joint and several liability, for the payment of the VAT.¹⁰⁵

The proposal is to replace Article 205 of the RVD with a new Article with two paragraphs. There are no changes in the first paragraph so the proposal is in reality only adding new paragraph to Article 205 that reads as follows:

2. In the situation referred to in Article 200,¹⁰⁶ the person supplying goods in accordance with the conditions laid down in Article 138,¹⁰⁷ shall be held jointly and severally liable for the payment of the VAT due on the intra-Community acquisition of those goods where he has not complied with the obligation provided for in Articles 262 and 263 to submit a recapitulative

¹⁰² COM(2004) 260 final, p. 14-15; COM (2006) 254 final, p. 9; COM(2007) 758 final, p. 11.

¹⁰³ COM(2006) 254 final, p. 9; COM(2007) 758 final, p. 4; Commission, "Report on the state of play of the discussions on the conventional measures to combat VAT fraud proposed by Member States" (Commission Staff Working Document) SEC(2007) 1584, p. 6; Commission, 'Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee on a coordinated strategy to improve the fight against VAT fraud in the European Union' COM(2008) 807 final, p. 8.

¹⁰⁴ Commission, 'Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards tax evasion linked to import and other cross-border transactions' COM(2008) 805 final and 2008/0228 (CNS).

¹⁰⁵ COM(2008) 805 final, p. 3-5.

¹⁰⁶ VAT due on intra Community acquisitions.

¹⁰⁷ Zero rate.

statement containing the information concerning the supply or the recapitulative statement submitted by him does not set out the information concerning this supply as required under Article 264.

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.¹⁰⁸

According to this proposal, intra-Community suppliers of goods shall be liable for the payment due on intra-community acquisition if they fail to submit a recapitulative statement on the right time or if the information on the statement is wrong. The only thing that can save them from this liability is if their customers have submitted a VAT return on the right time with all the information regarding the transaction or if the supplier can duly justify to the satisfaction of the authorities their shortcomings.

The intention of this proposal is good, it aim is to collect information about intra-community supply and acquisition faster and more correctly. Still, it is a question of whether this may not be done with gentler methods. It is also a question of whether enforcement of such a rule can be justified where a trader can be held liable for the VAT payment for his mistake of submitting a report that did not cause the fraud.

In the Explanatory Memorandum it is claimed that the proposal is in compliance with the principle of legal certainty and proportionality. It is stated that the condition of legal certainty for the trader involved is fulfilled as the rule in the proposal presents a clear and precise obligation so that taxable person may know without uncertainty what rights and obligations they have and can take measures accordingly.

This proposal features an additional legal base for the Member States to collect the VAT due on the intra-Community acquisition from a taxable person involved in a fraudulent transaction or a chain of transactions that would increase the risk and costs of those fraudsters. This would also improve the quality of the data that is transmitted through the value added tax

¹⁰⁸ Article 1(2) of the Commission proposal no. 2008/0228 (CNS).

information exchange (VIES) system as this will be an impulsion for the supplier to submit his recapitulative report timely, correctly and complete.¹⁰⁹

The proposal seems to be constructed on the presumption that taxable persons who fail to report their intra-Community properly are engaged in fraud unless they disprove this presumption by duly justifying their shortcoming.¹¹⁰

The Council adopted other parts of the proposal then the addition to Article 205 on 25 June 2009 with Council Directive 2009/69/EC amending Directive 2006/112/EC on the common system of value added tax evasion linked to import.¹¹¹ The Council split up the proposal and stated that it would continue its discussions. As more time passes from when it was presented it will be unlikely that it will be adopted, even with considerable changes.¹¹²

To evaluate effectuality of the provisions that are in the proposal it is necessary to look at advantage and shortcomings of the proposal. It seems like the main advantage is that the information in the VIES system will be more trustworthy and timely. It will also have some preventative effects on VAT fraud but whether it will stop VAT fraud is unlikely.

It seems though that the goal to improve the submission of information to the VIES system can be obtained with gentler methods.

Suppliers negligence in submitting recapitulative statements on time or with valid information is sufficient to hold them liable for intra-Community acquisition and it does not matter whether or not a VAT loss has occurred, whether they have anything to do with VAT fraud, or what reasons are behind his customer having not submitted a VAT return. Without this kind of connection, the liability in the proposal can lead to that honest suppliers will have to pay VAT because of formal mistakes. When even honest businesses run the risk of being exposed to being held jointly and severally liable for their customer's tax it can clearly act as a potential disincentive to intra-Community trade.

¹⁰⁹ Ben J M Terra, *The VAT Package and anti-tax fraud measures* (Series on International Indirect Tax University of Lund Volume 2, ETIL 2010), p. 230; Ine Lejune, Silvia Kotanidis and Ellen Cortvriend (2009), p. 368.

¹¹⁰ Ine Lejune, Silvia Kotanidis and Ellen Cortvriend (2009), p. 365.

¹¹¹ Council Directive 2009/69/EC of 25 June 2009 amending Directive 2006/112/EC on the common system of value added tax as regards tax evasion linked to imports *OJ L17 4.7.2009*, p. 12.

¹¹² Ine Lejune, Silvia Kotanidis and Ellen Cortvriend (2009), p. 368; Ben J M Terra, *The VAT Package and anti-tax fraud measures* (2010), p. 240; Council, 'Press Release 2948th Council meeting Economic and Financial Affairs' 10737/09 (Presse 168), p. 27.

It is a violation on VAT rules to not account for VAT on an intra-Community supply but that violation is not sufficiently serious to justify the supplier's pay the non-declared tax.¹¹³

In the proposal the liability is not ranked in a way that if the supplier becomes held jointly and severally liable it is not sure whether it would be possible to go first to the supplier before the VAT is collected from his customer.¹¹⁴

In a position on the proposal for EU-wide joint and several liability rules for intra-community acquisition it is declared that this proposal is not supported by BUSINESSEUROPE.¹¹⁵ There are three main reasons given for that conclusion and they are:

- It would create new obstacles to the establishment of the Internal Market by significantly enhancing the VAT-related risks for cross-border supplies.
- As long as there is no harmonized set up of VAT rules in Member States, there will be reporting mistakes. The assumption of guilt contained in the proposal is shifting the burden of proof to the supplier and could lead to significant litigation costs.
- If the aim is to improve the quality of reporting, other measures, such as penalties, could be used. The use of joint and several liability is not proportionate to this aim.¹¹⁶

At a meeting on 31 March 2009 in Working Party on Tax Questions changes on this proposal were discussed and the Presidency had suggested new amendments to Article 205 that include significant changes that are according to some of the criticism that have been made on the original proposal.¹¹⁷ Whether a new proposal or amendments to change Article 205 of the RVD will come from the Council is hard to predict.

5. The Knowledge test

5.1 Description and EJC cases

The ECJ introduced the so-called "knowledge test" in its judgment in the joined cases C-439/04 and C-440/04,¹¹⁸ *Kittel & Recolta*. In that case ECJ presented for the first time a link between the taxable person's rights to

¹¹³ Ine Lejune, Silvia Kotanidis and Ellen Cortvriend (2009), p. 365.

¹¹⁴ Ine Lejune, Silvia Kotanidis and Ellen Cortvriend (2009), p. 366.

¹¹⁵ The Confederation of European Business a.i.s.b.l. WWW.BUSINESSEUROPE.EU

¹¹⁶ The Confederation of European Business a.i.s.b.l., 'BUSINESSEUROPE Position on the proposal for a Council Directive amending Directive 2006/112/EC on the Common system of value added tax regards tax evasion linked to import and other cross-border transactions' (BUSINESSEUROPE position paper 17 March 2009 <<http://www.buisnesseurope.eu/content/default.asp?PageID=609>> accessed 8 May 2012).

¹¹⁷ Ben J M Terra, *The VAT Package and anti-tax fraud measures* (2010).

¹¹⁸ Joined Cases C-439/04 *Axel Kittel v État Belge* C-440/04 *État Belge v Recolta Recycling SPRL* 2006 ECR I-06161 (*Kittel & Recolta*).

deduct and the payment of VAT by other taxable person and by doing so put new responsibilities on the customers. This link is based on the taxable person's knowledge of VAT evasion.¹¹⁹

The knowledge test has been put forward as follows:

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.¹²⁰

Taxable persons that take every precaution which could be reasonably required to ensure that their transactions are not connected with fraud would not be confronted with a loss of the right to deduct input VAT.¹²¹

It seems like the outcome in the Kittel & Recolta case stems from some Member States rejecting deduction of input VAT when that transaction was a part of a MTIC fraud or carousel fraud. In a coverage about recovery of VAT in cases of detected missing trader fraud in a report from the Commission from 16 April 2004 it is stated that since there is no real possibility to recover VAT from the missing trader, an effective approach is to refuse the deduction or exemption of VAT to the other parties involved in the fraud.¹²²

The UK ran with a similar tactic but it was taken a little bit further. There the UK tax authorities adopted a tactic against carousel fraud which has been called the "non-economic argument." Their view was that when a circular trading chain only existed for the reason to fraud, it did not add anything to the natural distribution of goods and therefore it did not have economic foundations.¹²³ Transactions like that were considered to lack economic activity and therefore fall outside the scope of VAT.¹²⁴ On these grounds, one's participation in a circular trading chain, that the UK authorities considered a carousel fraud, was denied the claim to get the input VAT accepted and/or repayment of the VAT¹²⁵ and this was done without accusing the participant of being improperity.¹²⁶ The right for a taxable person, i.e. a non-consumer, to deduct input tax is the essence of the European VAT system and therefore was the use of this method by UK authorities disputed.¹²⁷

¹¹⁹ SEC(2010) 1455, p. 103.

¹²⁰ SEC(2010) 1455, p. 103; Ben Terra and Julie Kajus (2011), p. 339.

¹²¹ Redmar A Wolf (2010), p. 406.

¹²² COM(2004) 260 final.

¹²³ Colin Woodward, 'The Non-Economic Argument – Attempts to tackle Carousel Fraud in the United Kingdom, (2005) July/August International VAT Monitor 233.

¹²⁴ Colin Woodward, (2005) p. 233.

¹²⁵ Colin Woodward, (2005) p. 233; Colin Woodward, (2006) p. 240.

¹²⁶ Colin Woodward, (2006) P. 240.

¹²⁷ Ben J M Terra and Peter J Wattel, (2008) p. 173.

The Result of the UK authorities using this method meant that innocent traders could be denied to deduct input VAT if he got involved in a trading were had fraudster, which did not pay in the VAT, somewhere in the trading line. The circumstances in the EJC joined cases C-354/03, C-355/03 and C-484/03 Optigen, Fulcrum and Bond House¹²⁸ was like that. Those companies were trading with computer chips and the tax authorities refused to admit the input VAT from them on the base that their transactions formed a part of a supply which involved a defaulting trader without the companies, Optigen, Falcrum and Bond House, being aware of it. The UK upheld the “non-economic argument” and this trade fell out of the scope of VAT. The questions that were referred to the EJC in these cases were essentially whether transactions entered into by an innocent party, but which forms links in a carousel fraud by others can be excluded from VAT¹²⁹ and whether the right to deduct was limited in such circumstances. The outcome was that such transactions cannot be excluded from VAT regardless of the intention of the trader, other than the taxable person concerned, if the transaction fulfills the objective criteria on which the definition of the terms economic activity, supplies of goods and services and a taxable person acting as such. The right of a taxable person to deduct input VAT cannot be affected by VAT fraud in the supply chain without that taxable person knowing or having any means of knowing.

Joined Cases C-439/04 and C-440/04 Kittel & Recolta

Computime, a company in Belgium, traded in computer components which it bought in Belgium and sold in other Member States. The tax authority’s standpoint was that Computime knowingly took part in carousel fraud as it had traded with the same package of Pentium Intel CPU microprocessor repeatedly from 10 January to 30 June 1997.¹³⁰ Computime’s supplier never paid the VAT. Computime was in liquidation and was represented by its receiver, Axel Kittel.

Recolta bought 16 luxury cars from Mr. Aillaud and resold them to Auto Mail for distribution in other Member States, a supply that was without VAT. Mr. Aillaud and Auto-Mail were running a carousel fraud scheme and the cars never left Belgium nor did they pay the VAT. In a court case in connection with this case the court stated that there was nothing that indicated that Recolta and its directors knew or had any suspicion that they were involved in a fraud scheme.

¹²⁸ Cases C-354/03 Optigen Ltd, C-355/03 Fulcrum Electronics Ltd and C-484/03 Bond House Systems Ltd v. Commissioners of Customs & Excise 2006 ECR I-00483

¹²⁹ Ben Terra and Julie Kajus, (2011), p. 335.

¹³⁰ Cases C-439/04 *Axel Kittel v État Belge* C-440/04 *État Belge v Recolta Recycling SPRL* 2006 ECR I-06161, Opinion of AG Ruiz-Jarabo Colomer, footnote 9.

According to Belgian law¹³¹ obligations with no basis or with a false or unlawful basis could not be legitimate whatsoever. On these grounds Tax authorities denied Computime and Recolta the deduction of the input VAT. This led to court cases where two questions were referred to the EJC for a preliminary ruling.

Essentially the referring court questions were firstly whether a taxable person could be denied to deduct input VAT if he did not know and could not know about fraud that involved a sale contract that was void according to national law because of an action from the seller. Secondly whether the answer to the first question would be different where the taxable person knows or should have known about the VAT fraud.

The Court follows the reasoning from the *Optigen* judgment regarding the first question so it is almost precisely the same. The only addition is from the *FIT* judgment and then the Court states that in the light of the abovementioned it is obvious that:

[...] traders who 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, must be able to rely on the legality of those transactions without the risk of losing their right to deduct the input VAT”¹³².

The decision for the first question was that the taxable person's right to deduct input VAT cannot be affected by fraud if he did not know and could not know about the fraud.¹³³

The Court continues to rationalize the answer to the second question about whether the question would be different when the taxable person is aware of a fraud. It starts by concluding that where tax is evaded by the taxable person the objective criteria¹³⁴ are not met.¹³⁵ To prevent tax evasion, avoidance and abuse is a goal that is accepted and inspired by the Sixth Directive and community law cannot be relied on for abusive or fraudulent ends.¹³⁶

¹³¹ Article 1131 and 1133 of the Belgian Civil Code.

¹³² The *Kittel & Recolta* Case, para 51.

¹³³ The *Kittel & Recolta* Case, para 52 and 62.

¹³⁴ The objective criteria which form the basis of the concepts of 'supply of goods effected by a taxable person acting as such' and 'economic activity.'

¹³⁵ Regarding this the Court refers to Case C-255/02 *Halifax and Others*, paragraph 59, but that paragraph is as follows: "It is true that those criteria are not satisfied where tax is evaded, for example by means of untruthful tax returns or the issue of improper invoices. The fact nevertheless remains that the question whether a given transaction is carried out for the sole purpose of obtaining a tax advantage is entirely irrelevant in determining whether it constitutes a supply of goods or services and an economic activity."

¹³⁶ The *Kittel & Recolta* Case, para 54.

The Court refers to the Cases *Rompelman*, *INZO* and *Gabalfrisa*¹³⁷ to supporting the case law that where the right to deduct has been exercised fraudulently, tax authorities are permitted to claim repayment of the deducted sums retroactively.

Taxable person that know or should have known about fraud must for the purpose of the Sixth Directive be regarded as a participant in that fraud, irrespective of whether or not he profited by it.

Two additional explanations are given for this resolution. Firstly in such situation the taxable person help the offenders with the fraud and becomes their accomplice.¹³⁸ Secondly such interpretation makes it more difficult to carry out fraud and therefore is likely to prevent them.¹³⁹

The Courts ruling in the second question is for the national court to refuse that taxable person the right to deduct the VAT where it is ascertained that the supply is to a taxable person who know or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of VAT.¹⁴⁰

Here the court steps away from the Advocate General Opinion from Ruiz-Jarabo Colomer for this case as his opinion was that taxable person how were aware of the fraud and did not derives a financial advantage from it should not lose his right to deduction of VAT.¹⁴¹ It looks like the Court have follow more the line that were laid down by Poiares Maduro in his opinion in the *Halifax Case*, *Optigen Case* and *FTI Case* and was follow in the rulings of those cases.

ECJ Case C-285/09 Criminal proceedings against R¹⁴²

The Criminal R was a manager of a German company trading with luxury cars and he sold cars to Portuguese car dealers. They did not intend to declare the intra-community acquisitions and sold the cars to private individuals without paying VAT. R concealed the true identity of the real purchasers by drawing up a second set of invoices to fictitious purchasers and could therefore demand higher prices. As the transaction of the cars was intra-Community supply R claimed that it were zero rated. The tax authorities in

¹³⁷ Case 268/83 *Rompelman* para 24, Case C-110/94 *INZO* para 24 and joined Cases C-110/98 and C-147/98 *Gabalfrisa and Others* para 46.

¹³⁸ The *Kittel & Recolta Case*, para 57.

¹³⁹ The *Kittel & Recolta Case*, para 58.

¹⁴⁰ The *Kittel & Recolta Case*, para 57.

¹⁴¹ Cases C-439/04 *Axel Kittel v État Belge* C-440/04 *État Belge v Recolta Recycling SPRL* 2006 ECR I-06161, Opinion of AG Ruiz-Jarabo Colomer, para 61-63.

¹⁴² ECJ Case C-285/09 *R. V. Generalbundesanwalt beim Bundesgerichtshof, Finanzamt Karlsruhe-Durlach* OJ C55 19.2.2011, p. 10 (The criminal R Case).

Germany denied R the right to zero-rate the supplies of the cars since R enabled the evasion of VAT in Portugal.¹⁴³

In connection to Criminal Case against R a German court asked for preliminary ruling from ECJ where the essence of the question was can Member State refuse allow an exemption to zero-rate intra-Community supply when the taxable person know he was participating to evade VAT or the taxable person took action aimed at concealing the true identity of the purchaser in order to enable that person or third person to evade VAT.

The Court observed that:

[T]he presentation of false invoices or false declarations and any other manipulation of evidence is liable to prevent the correct collection of the tax and, therefore, to compromise the proper functioning of the common system of VAT. Such actions are all the more serious when committed in the context of the current arrangements for the taxation of intra-Community transactions, which are based on evidence provided by taxable persons.¹⁴⁴

Consequently EU law does not prevent Member State from handling the issuing of unlawful invoices equal to tax evasion and from refusing to grant the zero-rate exemption in such incidents.

The principle of proportionality does not preclude supplier from being obliged to pay VAT on his intra-Community supply if he participate in tax evasion with involvement as a decisive factor.

A taxable person who has deliberately participated in tax evasion and who has put at risk the operation of the common system of VAT cannot legitimately raise for his defense the principles of fiscal neutrality, the principle of legal certainty or the principle of the protection of legitimate expectations.¹⁴⁵

The decision of the Court was that Member State may refuse taxable person claim for zero-rate exemption on intra-Community supply if he conceal the identity of the true purchaser in order to enable VAT evasion in other Member State.

The Court did not stop there and went further and declared that Member States are even required to refuse the application of the zero-rate exemption if

¹⁴³ Ben Terra and Julie Kajus, 'A Guide to the Recast VAT Directive' (Commentary IBFD Tax Research Platform, reviewed 15 January 2012) assessed 23. May 2012, ch. 3., Jochen Meyer-Burow and Ocka Stumm, 'Recent Development in German Criminal Law and Their Impact to VAT Compliance' (2011) May/June International VAT Monitor 161, p. 163.

¹⁴⁴ Jochen Meyer-Burow and Ocka Stumm (2011) p. 164; the criminal R Case, para 48.

¹⁴⁵ The Criminal R Case, para 54.

there are genuine reasons to assume that the taxable person's action have the effect that the transaction in question might escape payment of VAT in the Member State of destination.¹⁴⁶

In the Commentary, in a Guide to the Recast VAT Directive, Ben Terra and Julie Kajus, stated that the Court in the Criminal R Case does not follow its own precedent and point especially on the three cases where illegal transactions was not held to be sufficient to allow exemption.¹⁴⁷

It is strange outcome, which need more examination, that when taxable person participate deliberately in tax evasion that none of the above mentioned principles can be invoked by him.

The Criminal R case calls for update on the knowledge test as according to it issuing unlawful invoices can be treated as tax evasion and Member State can refuse to grant a zero-rate exemption in such cases. The ECJ court state that Member States must refuse to grant such exemption, if there are genuine reasons to assume that the taxable persons actions have the effect that the VAT will not be paid in the other Member State.

Is seems that to the knowledge test can be added new rule that read something like this:

Member State must refuse the application of exemption from VAT on intra-community supply if the action of the taxable person can be assumed by genuine reasons to lead to the VAT in the Member State of destination will go unpaid that the VAT

There are three pending cases from Hungary before the EJC that will be interesting to see the outcome in. The first two are joined cases C-80/11 Mahagében and Case C-142/11 Péter Dávid.¹⁴⁸

In the Mahagében case the main issue in the case seems to be the second question that states:

Is the concept of due diligence set out in Paragraph 44(5) of the Hungarian Law on VAT compatible with the principles of neutrality and proportionality already upheld several times by the European Court of Justice in connection with the application of the Directive if, in applying that concept, the tax authority and established case-law require the recipient of the invoice to ascertain whether the issuer of the invoice is a

¹⁴⁶ Jochen Meyer-Burow and Ocka Stumm (2011) p. 164; The criminal R Case, para 52.

¹⁴⁷ Ben Terra and Julie Kajus, 'A Guide to the Recast VAT Directive' (2012), ch. 3.

¹⁴⁸ ECJ Cases C-80/11 *Mahagében* Reference for a preliminary ruling from the Baranya Megyei Bíróság (Hungary) lodged on 22 February 2011 and Case C-142/11 *Péter Dávid* Reference for a preliminary ruling from the Jász-Nagykun-Szolnok County Court (Hungary) lodged on 23 March 2011 (pending).

taxable person, whether it has entered goods purchased in its records and is in possession of the purchase invoice, and whether it has satisfied its obligations as to declaration and payment of VAT?¹⁴⁹

Here it seems like Hungary has extra requirement for deduction of VAT as some special document is needed to confirm a sale of a product. The invoice is not enough for deduction of the VAT and it done to prevent VAT evasion. Here are more requirements that taxable person needs to fulfil. To give a good answer it is needed to look on the national law and evaluate what purpose this requirement has and whether this way is in line with principle of proportionality. Can the same purpose been gain with other milder methods and dose those rules really work on tax evasion? Here rise up the similar questions as in the knowledge test, what is required from taxable person so he can say that he should not have known about a fraud. When is enough, enough? According to the results in the Criminal R case Member State can treated unlawful issuing of invoices as Tax evasion however whether this special document can fall there under depends on whether a foot can be found for such document or requirement can be found in invoicing rules in Article 217 to 240 of the RVD.

In the Péter Dávid Case the question is about the deduction rules in the VAT system and whether the deduction right may be restricted or prohibited by tax authorities if the invoice issuer cannot guarantee that involvements of further subcontractors complied with the rules?

Can tax authorities lawfully prohibit a VAT refund if the identity of other subcontractors used by the invoice issuer cannot be determined, or invoices have not been issued in accordance with the rules by the other subcontractors?

Is a tax authority which prohibits the exercise of the right of deduction obliged to ensure during its procedures that the taxable person with the right of deduction was aware of unlawful conduct, possibly engaged in for the purpose of tax avoidance, of the companies behind the subcontracting chain, or even colluded in such conduct?

Case C-324/11 Tóth¹⁵⁰ (Pending)

In this case the problem is, as in the other two, with the right to deduct VAT and invoices for example when the issuer has lost his operator licence, the issuer has not declared the workers that he employs, the work buyer has not verified whether legal relationship exist between the workers on the work site or a invoice issuer has fulfilled his tax-return.

¹⁴⁹ Joined Cases C-80/11 *Mahagében* and C-142/11 *Péter Dávid* (pending).

¹⁵⁰ Case C-324/11 *Tóth* Reference for a preliminary ruling from the A Magyar Köztársaság Bírósága (Hungary) lodged on 29 June 2011 (pending).

The Péter Dávid case and the Tóth case are on similar line as the Optigen Cases and Kittel & Recolta Cases. It is likely that same line will be follow so Member States will not be able to restrict the right to deduct VAT when taxable person does not know or not able to know about VAT fraud. However if he know or should have known about the fraud deduction will not be allowed. Maybe there will be need for better rules to fight black marked fraud but it can be harmful to lay too much burden on taxable person to act like a tax authorities when they are doing business. It is unfair to lay the risk on revenue loss on the taxable person. In both of this cases it seem like some part of it shall be attend with criminal law and it not something that VAT legislation can deal with. It look like reverse charge could help in situation as are in the Tóth case.

5.2 Advantage and shortcoming of the Knowledge Test

Taxable person have to take every precaution which could reasonable by required from them to ensure that their transaction are not connected with VAT fraud. This is requirement follow the knowledge test and it shall be remembered that the consequential risk of being held indirectly liable for fraud committed by somebody else can be there for a several years from the day the transaction took place.¹⁵¹

It has been repeat for the ECJ court that repeat traders who 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, must be able to rely on the legality of those transactions without the risk of losing their right to deduct the input VAT.¹⁵²

The knowledge test has had effect on taxable person and there business. Taxable persons have to demonstrate that they took every precaution which could be reasonable be required to ensure that their transactions were not connected with fraud if they for example purchase goods from missing trader. There is no standard for the precaution which a taxable person shall follow in order to secure his rights. It depends on the facts and circumstances of each individual transaction what is reasonable.¹⁵³ A uncertainty of what can be reasonably be requested from taxable person so he shows a enough diligence or not is burden on the business in EU, burden that can be costly and be hinder for the internal marked.

Tax authorities must be able to prove that a connection exists between the transaction and VAT fraud. When that has been established tax authorities may refuse deduction of VAT of any trader who know or should have known that he was participating in trade what was connected with fraud. The

¹⁵¹ SEC(2010) 1455, p. 12.

¹⁵² The Kittel & Recolta Case, para 51; the FTI Case, para 33.

¹⁵³ Redmar A Wolf (2010), p. 406.

knowledge should be based on objective factors. Further instructions did ECJ not provide.¹⁵⁴

It is for the courts of the Member States to decide whether the conditions in the Knowledge Test are fulfilled or not. This is similar evaluation as is in many law provisions and rules that call for liability if someone knows about fraud. For example in the Community Custom Code¹⁵⁵ Article 202(3) the debtors are also the person who knowingly either participated in an unlawfully introduction of goods or held the goods.¹⁵⁶ Because the evaluation about whether the Knowledge Test fulfilled or not is in the hand of national courts it can lead to variable results and there is a risk that taxable persons will be treated different after what Member State he is in and the outcome can even be different in the same supply chain when the transaction is intra-Community supply.

As was said above it is unsolved and unsure when a taxable person is doing enough to be aware that his supplier or others in the supply chain are not embezzling the VAT. When do taxable person know such things and when not? Shall the same knowledge test apply for a specialist in VAT law as for a person who just started his business? In the EJC Case C-64/89 *Deutsche Fernsprecher GmbH* and Case C-48/98 *Firma Sohl & Söhlke* it is said that regard must be taken in particular of the precise nature of the error, the professional experience of, and the care taken by, the trader and in both cases is in the ruling said that account must be taken to the professional experience of trader when 'obvious negligence' is determined¹⁵⁷. These cases are customs cases but show that EJC have seen it so that professional experience can be part of an estimate for 'obvious negligence' and it can therefore also have meaning when knowledge is estimated.

It will be the national courts to judge on whether authorities have used the knowledge test on right way and then they will need to take into account the EU law and EU principle, as the principle of proportionality. It is also question where shall a taxable person go if authorities in Member State and the national court interpret the Knowledge test too strictly? It is though sure that in some cases the taxable person can go to the European Court of Human Rights to get results if other ways are closed¹⁵⁸

¹⁵⁴ Redmar A Wolf (2010), p. 406.

¹⁵⁵ Council Regulation (EEC) No 2913/92 of 12 October 1992 establishing the Community Customs Code *OJ L 302, 19.10.1992 p. 1.*

¹⁵⁶ Ben Terra, 'The Community Customs Code' (Unpublished part of book used in Course in European and International Tax Law in University of Lund HARN59), cp. 3.2 (a).

¹⁵⁷ EJC Case C-64/89 *Hauptzollamt Gießen v Deutsche Fernsprecher GmbH* 1990 ECR I-02535, para 19, 21 and 24; Case C-48/98 *Firma Söhl & Söhlke v Hauptzollamt Bremen* 1999 ECR I-078771999, para 55, 57 and 60.

¹⁵⁸ Philip Baker, 'Some Recent Cases from the European Court of Human Rights' (2009) June European Taxation 326.

6. Connection between these methods

The reverse charge mechanism can be used whether or not the Member State adopt provision about joint and several liability and the latter can even strengthen the defence against VAT fraud that the reverse charge can give when the goods or the service are sold to customer and non-taxable persons. It could also help to use this two method in the fight against use of black marked workers, for example if contractor that is under the reverse charge buys service from subcontractor that uses black marked workers the contractor could be maid liable for it if he know about it.

The same can be said about the reverse charge and the knowledge test but the knowledge test is not something that Member State adopts as it is already part of the VAT system of the EU as ECJ case law.

Member States legislation about joint and several liability may not be in contrary to EU law in particular the principles of legal certainty and proportionality. There is connection between the joint and several liability method and the knowledge test as can be seen on the EJC judgements where it has been said that to strict liable rule can go beyond what is necessary and be breach of the principle of proportionality. In both system good faith matters and it often also is the same speculations about what person know or should have known.

By adopting joint and several liability Member State can make person liable to pay VAT that the he for example helped someone to embezzle. The knowledge test cannot make someone liable for VAT. It can only deny someone to deduct input VAT or deny someone to use exemption as zero-rates. Taxes can only be levied with national legislation and as the knowledge test is just based on EU Directive it is hard see that it can be base to levy taxes.¹⁵⁹

¹⁵⁹ Condition to levy taxes is not the same in all country but I cannot see that no Member State can levy taxes with EU regulation.

7. Summary

The EU and the Member States are concerned about VAT fraud and they consider it necessary to reduce the gap the VAT fraud makes. The purpose of this thesis is to describe three methods that are used in the fight against VAT fraud. Those methods are the reverse charge mechanism, joint and several liability and the knowledge test. Those methods are described, defined how they are used and what are the pros and the cons that follow them.

The VAT fraud can be miscellaneous but it is helpful to categories them in two main categories: Black marked fraud and MTIC fraud. Carousel fraud fall under MTIC fraud and can be the very harmful as they are often organized so they can be reduplicate to embezzle as much VAT as possible before the authorities can stop them.

The reverse charge methods works well on MTIC and carousel fraud that are the most serious of the VAT fraud. The problem with the reverse charge is that it is not advisable to use it to general or on to many sectors as it will have negative effective on the VAT system. The best is to use the reverse charge on the sectors that are most sensitive for VAT fraud. However it is only temporary solution. A general reverse charge system is not recommended by the Commission.

Joint and several liability can also work well to fight VAT fraud. Member State must adjust those rules so they comply with general principles of law which form part of the Community legal order, in particular, the principle of legal certainty and proportionality. Case law have had influence on this method and according to it a rule that makes person liable when he is in good faith or no fault or negligence can be imputed to him is in breach with the right interpretation of Article 205 of the RVD. The Commission introduced proposal in December 2008 for EU-wide joint and several liable rules that will held taxable person liable for the payment of the VAT if he don't fulfill his obligation in reporting his intra-Community supply. It has not been adopted by the Council and it seems unlikely that it will by adopt.

The knowledge test can be useful for tax authorities of the Member State but it put too heavy burden on taxable person while it is not clear how they shall act or how they shall show precaution. The ECJ case 295/09 has added new part to the knowledge test and states that Member State must refuse the application of exemption from VAT on intra-community supply if the action of the taxable person can be assumed by genuine reasons to lead to the VAT in the Member State of destination will go unpaid.

The reverse charge mechanism works well with both joint and several liability and the knowledge test an can even improve them. The other two methods are in many parts similar but while other make person liable for VAT the other refuses deduction of input VAT or zero-rate on intra-Community supply.

Annex

In Article 193 of the RVD are exception from the main rule that VAT is payable by any taxable person carrying out a taxable supply of goods or services and according to the provision. Those exceptions can be found in Articles 194 to 199 and Article 202 and then often is the exception involved in a reverse charge.

Article 194 RDV

Member States may make person liable for payment of VAT that receive goods or services from taxable person who is not established in that Member States.

Article 195 of the RDV

A supply of gas, electricity and heat or cooling energy shall be under the revers charge mechanism so taxable dealer established inside or outside of the Member State in which the VAT is due is liable for it.

Article 196 of the RDV

Place of supply of service to a taxable person shall be the place where he has established his business according to Article 44 of the RVD. If the service that is referred to in Article 44 of the RVD is supplied by taxable person that has not established within the Member State of the receiver the receiver become liable for the VAT payment as is stated in Article 196.¹⁶⁰

Article 197 of the RDV

In case of triangulation the reverse charge is provided by Article 197(1) of the RVD and Article 197(2) makes a tax representative available to be liable for the VAT payment in cases of the 1 paragraph of the Article.¹⁶¹

Article 198 of the RDV

Reverse charge mechanism shall be applied for investment gold in order to prevent VAT fraud.¹⁶²

Article 199 of the RDV

Member States may lay the liability for the payment of VAT on the person that supplies are made to in following supply of:

- a. construction work, including repair, cleaning, maintenance, alteration and demolition services in relation to immovable property but also handing over construction work;
- b. staff engaged in activities cover in point a;

¹⁶⁰ Article 44 and 196 of the RVD was replaced by new Articles from 1 of January 2010 by Article 2 of the Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services *OJ L 44 20.2.2008 p. 11.*

¹⁶¹ Ben Terra, *Introduction to VAT and the VAT of the European Union* (2011) cp. 2.12.1.

¹⁶² Ben J M Terra and Peter J Wattel (2008), p. 199.

- c. a building or parts thereof, and of the land of which it stands other than before first occupation and land which has not been built on other than building land where the supplier has opted for taxation as is permitted in Article 137;
- d. used material, scrap and waste and certain goods and services as listed in Annex VI;
- e. goods provided as security by one taxable person to another in execution of that security;
- f. goods following the cession of a reservation of ownership to an assignee and the exercising of this right by the assignee;
- g. immovable property sold by a judgement debtor in a compulsory sale procedure.

Article 199a of the RDV

Member State may temporary use revers charge mechanism on transfer of allowances to emit greenhouse gases.

Article 202 of the RDV

This provision is not about a reverse charge but permits Member State to make person liable for VAT in specific circumstances.

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