



FACULTY OF LAW  
University of Lund

Karolin Karlsson

# Reverse Charge Mechanism

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Supervisor: Christina Moëll

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# Summary

The purpose of this thesis is to examine whether the reverse charge mechanism is an efficient method to solve the VAT fraud problem in the construction sector in Sweden. To be able to answer the stated question, the effects of the reverse charge mechanism will be evaluated. The effects of the reverse charge mechanism are then analysed as to whether they are proportional to the goal, which is to decrease the tax fraud in the construction sector.

In 2007, Sweden introduced the reverse charge mechanism in the construction sector. The aim of the introduction was to stop tax fraud, which is dominant in this sector. Tax fraud is usually done by artificial arrangements. Companies are often established for the sole purpose of sending false invoices. They receive the payment from the buyer, including VAT. As soon as they receive the payment the artificial companies disappear, without paying the output VAT to the tax authorities. At that time, the seller has deducted input VAT. The result is that the state loses huge amounts of VAT. The VAT is collected but never paid to the tax authorities. This also distorts competition among the economic actors.

The reverse charge mechanism is a derogation scheme to the main scheme of VAT. It is the buyer who is liable for the payment of VAT. The buyer can thus deduct the VAT. The result is that the supplier never gets access to the VAT and then do not benefit from artificial arrangements. The payment of VAT to the tax authorities is postponed to the last supplier in a contractor chain.

Negative effects of the reverse charge mechanism are that it can affect the liquidity for the supplier and the state. The reverse charge mechanism also can constitute an obstacle to the free movement of smaller companies. Most critics have been concerned by the uncertainty of the legislation's definitions of services and companies, to which the reverse charge mechanism is to be applied. Positive effects are the reduction of VAT fraud and the liquidity for the customer and for smaller companies.

To conclude, the reverse charge mechanism is an efficient method to combat VAT fraud in the construction sector since the fraud consists of artificial arrangements down the supplier chain and the reverse charge mechanism puts more pressure on suppliers further up the chain and the supplier never gets access to the VAT.

The effects of the reverse charge mechanism will be proportionate to the goal, in order to decrease VAT fraud. The uncertainties concerning the definitions and the administrative burden will probably decrease when the reverse charge mechanism has been applied for a longer time. The writer thus concludes that the reverse charge mechanism is a short term solution to a long term and on going problem.

# Sammanfattning

Syftet med denna uppsats är att utvärdera huruvida den omvända skattskyldigheten är en effektiv metod att använda för att bekämpa skattefusk. För att kunna svara på denna fråga kommer effekterna av den omvända skattskyldigheten att utvärderas. Dessa effekter skall därefter ställas mot målet med införandet av den omvända skattskyldigheten för att se om dessa är proportionella.

Sverige införde 2007 omvänd skattskyldighet inom byggsektorn. Syftet med införandet var att hindra skattefusket som var uppseendeväckande i just denna sektor. Skattefusket är ofta gjort med hjälp av uppsättande av företag som är etablerade med enda syfte att uppnå skattefördelar. Dessa företag får betalningar från kunder. Så snart de får betalt, inklusive moms, så försvinner företaget utan att betala någon utgående moms till skatteverket. Samtidigt gör säljaren av tjänsten avdrag av sin ingående moms. Resultatet bli att stora summor moms blir uppsamlade men aldrig inbetalda till skatteverket och därmed blir förlusterna för staten stora. Det bidrar också till att konkurrensen snedvrids på marknaden.

Den omvända skattskyldigheten är ett undantag till huvudsystemet av moms. Det är köparen som blir skattskyldig och också den som kan dra av momsen på sin faktura. Resultatet blir att säljaren aldrig får tillgång till momsen. Därmed lönar det sig inte att etablera företag vars enda syfte är att kunna tillgodogöra sig moms olagligt. Betalningen av momsen till skatteverket blir på detta sätt framskjuten till den sista säljaren i ledet, som säljer till ett företag som inte uppfyller kraven för omvänd skattskyldighet.

Negativa effekter av den omvända skattskyldigheten är bland annat att den kan påverka likviditeten för säljaren och staten. Det har också argumenterats om att det är ett hinder för den fria rörligheten för mindre företag då reglerna är för komplexa. Mest kritik har den omvända skattskyldigheten fått för dess osäkerhet angående för vilka tjänster och vilka företag som den skall tillämpas på. Positiva effekter är minskningen av skattefusk och likviditetsförbättringar för köpare och mindre företag.

Sammanfattningsvis är omvänd skattskyldighet en effektiv metod för att motverka skattefusket i byggsektorn. Dels för att fusket mest görs med artificiella etableringar av företag längre ner i entreprenadskedjan och den omvända skattskyldigheten sätter mer vikt på säljare längre upp i kedjan, och dels för att säljaren aldrig får tillgång till momsen.

Effekterna av den omvända skattskyldigheten kommer att bli proportionella till målet dvs. att minska skattefusket. Osäkerheten kring definitionerna av vilka tjänster och vilka företag som skall omfattas av den omvända skattskyldigheten kommer antagligen att minska när den har blivit mer etablerad som system. Författaren tror dock att den omvända skattskyldigheten är en kortsiktig lösning på ett pågående och ej kortsiktigt problem.

# Preface

Firstly I would like to thank my supervisor Christina Moëll for her help and support throughout the work of my thesis. Her availability and friendliness have made the working process of this thesis excellent.

I would also express my great appreciation to my family and in particular my parents and my grandmother for their invaluable encouragement and unconditional support throughout my years of studies at the Faculty of Law in Lund.

I would also like to thank assistant professor Xavier Groussot. His devotion to European Law has inspired me irrespective of which area of European law I have mastered. The skills I gained from my partaking in The European Law Moot Court Competition that Mr. Groussot led will always be a great guidance for further challenges in the field of European Law.

I am also grateful to Alexander Drugge, who helped me with the schedules on the different systems of tax collection in this thesis. I would also like to thank Andreas Talle-Holmqvist and Christina Grape for very interesting discussions and great input to my thesis.

# Abbreviations

Commission	European Commission
ECJ	European Court of Justice
EC Treaty	Treaty Establishing the European Community
EC	European Community
Ecofin	Economic and Financial Affairs Council
EU	European Union
ML	Mervärdesskattelagen
OECD	Organisation for Economic Co-operation and Development
SNI	Svensk Näringsgrensindelning
VAT	Value Added Tax
VAT Directive	Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

# 1 Introduction

## 1.1 Background

Tax fraud is a global problem. According to the International VAT Association, European Value Added Tax (VAT) fraud is ‘growing at an alarming rate – both in its quantum and its level of sophistication’.<sup>1</sup>

Outcomes of tax fraud are budget losses of the Member states, violation of the principle of fiscal justice, infringements of competition conditions and distortions of capital movement.<sup>2</sup> As a consequence of state budget losses, taxes have to be raised, which affects honest and serious competitors.<sup>3</sup>

Tax fraud in a specific sector distorts competition among the competitors, as actors choose to not pay VAT or other taxes to the tax authorities for the workers they have hired. This also affects the possibility for new actors to establish themselves on the market since the (distorted) competition is too tough. For the workers this results in employment without social insurance, pension-carrying insurance, or income insurance against damage or unemployment and also losses of benefits and guarantees, which usually are provided on the labour market. In the long run it is also more difficult to get other jobs. These outcomes also affect social welfare in the Member states.<sup>4</sup>

In the European Union (the EU) fraudsters take advantage of the four fundamental freedoms<sup>5</sup> by moving their activities very promptly in order to escape the reach of tax administrations at the national level. The main problem is the ease with which the buyer of goods and services can be given a valid claim to a refund of VAT that the seller has not yet paid and has no intention of paying. The free movement of goods and services within the internal market and also the globalisation of the economy make it difficult for Member States to act individually against tax fraud. The consequences of tax fraud prove the international character of the problem, whose effects extend beyond state boundaries.<sup>6</sup>

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<sup>1</sup> Combating VAT fraud in the EU – the way forward. Report presented to the European Commission – March 2007, p. 4

<sup>2</sup> 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 financial fraud (COM(2006) 254), p. 3

<sup>3</sup> Proposition 2005/06:130 Omvänd skattskyldighet för mervärdesskatt inom byggsektorn (Government bill 2005/06:130 Reverse charge mechanism in the construction sector) (Prop: 2005/06:130), p. 21

<sup>4</sup> Prop 2005/06:130, p. 20 and 21

<sup>5</sup> The four fundamental freedoms are; free movement of goods, capital, services and the right of establishment, which are stated in the EC Treaty in art 39, 43, 49 and 56.

<sup>6</sup> COM(2006) 254, p. 3

In 2005, 140 derogation schemes from the main scheme of VAT had been allowed to apply within the Member states for the purpose of combating VAT fraud. This illustrates that VAT fraud has grown to be a huge problem for the Member states in recent years. Both the national authorities of the Member states and the business federations have indicated that VAT fraud has become extensive in certain sectors, which puts trustworthy traders at a competitive disadvantage. This also facilitates dishonest traders to sell goods and services at lower prices than honest competitors.<sup>7</sup>

It has been a top priority for the European Commission (the Commission) to combat the VAT fraud problem and to find an efficient way to reduce the level of VAT fraud. The Commission has called on the Member states to step up coordination to fight the fraud.<sup>8</sup>

The Swedish tax authorities held in a memorandum in 2005 that the construction sector in Sweden is one of the sectors where VAT fraud problem is prevalent.<sup>9</sup> Often an artificial chain of sub-contactors is set up, where no output VAT is paid even though input VAT is deducted.<sup>10</sup> In July 2007, Sweden introduced the reverse charge mechanism in the construction sector to combat the increasing VAT fraud. The reverse charge allows the supplier of services not to charge VAT from his customer. The obligation to do so is passed on to the customer. This customer can consequently deduct this amount of self invoiced VAT when the services are used for business purposes.<sup>11</sup>

It has been argued that the reverse charge mechanism is burdensome and confusing for companies and may create new gaps within the VAT system and adverse effects in the Member states' tax administration. Furthermore, it has been argued that the reverse charge mechanism is not efficient since the administrative costs also increase for the companies and there are uncertainties concerning which companies qualify to use the reverse charge mechanism and which companies do not.<sup>12</sup> It has been argued that

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<sup>7</sup> Communication from the European Economic and Social Committee on the 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, p. 2

<sup>8</sup> 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, p. 3

<sup>9</sup> Skatteekonomiska meddelanden, nr 47, av den 7 oktober 2005 (Tax Financial News, no 47, on the 7th of October 2005) (Skatteekonomiska meddelande)

<sup>10</sup> Prop 2005/06:130, p. 20

<sup>11</sup> Mervärdesskattelagen (1994:200) (ML) (The Swedish VAT regulation) ML 1:2 1 paragraph 4bp and 1:2 paragraph 2

<sup>12</sup> Samlingsdokument Skatteverkets skrivelse angående yttrande av omvänd moms skyldighet, (Main document Tax authorities - statement concerning the reverse charge mechanism) (SKV:s skrivelse), p. 2

other techniques can be chosen to solve the tax fraud problem without uncertainties and increased costs for the companies.<sup>13</sup>

For the reader to follow this thesis more easily, the main scheme of VAT and the reverse charge is illustrated below.

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<sup>13</sup> Prop 2005/06:130, p. 33

**Scheme I - Main rule**

The supplier is liable for the VAT payment to the tax-authorities

**4. Customer**

<hr/>					<b>VAT to the tax authorities</b>
<b>Contractors and sub-contractors</b>					<b>Σ 500 (125 + 225 + 150)</b>
<b>3. Construction AB</b>					↑
Invoice: Services	2 000	<b>Output</b>	VAT	500	
VAT (25 %)	350	<b>Input</b>	VAT	350	= 150
Σ	2 500				
<b>2. Build AB</b>					↑
Invoice: Services	1 400	<b>Output</b>	VAT	350	
VAT (25 %)	350	<b>Input</b>	VAT	125	= 225
Σ	1 750				
<b>1. Wood AB</b>					↑
Invoice: Services	500	<b>Output</b>	VAT	125	
VAT (25 %)	125	<b>Input</b>	VAT	0	= 125
Σ	625				

**Scheme II - Derogation rule**

The customer is liable for the VAT payment to the tax authorities

**4. Customer**

<hr/>					<b>VAT to the tax authorities</b>
<b>Contractors and sub-contractors</b>					<b>Σ 500 (0 + 0 + 500)</b>
<b>OUTPUT VAT:</b>				<b>500</b>	= 500
<b>3. Snickeri AB</b>					↑
Invoice: Services				2 000	
VAT (25%)				500	
Σ				2 500	
<i>payment of VAT for services</i>					
1 400 x 25% =				350	
Refund				350	= 0
<b>NO OUTPUT VAT</b>					
<b>2. KonstruktionAB</b>					↑
Invoice: Services				1 400	
Without VAT					
<i>payment of VAT for services</i>					
500 x 25 % =				125	
Refund				125	= 0
<b>NO OUTPUT VAT</b>					
<b>1. Bygg AB</b>					↑
Invoice: Services				500	
Without VAT					

## **1.2 Purpose and aim**

The purpose and aim of this thesis is to examine whether the reverse charge mechanism is an efficient method to combat the VAT fraud problem in the construction sector in Sweden. The examination will consist of an inquiry into the effects of the reverse charge mechanism used as derogation to the main scheme of VAT in a specific sector.

To answer the question above, it is necessary to examine debated tax terms, which will be used within this thesis. It is essential to state the writer's definition of what constitutes 'tax fraud', since the term is disputed in the doctrine. The difference between tax evasion, tax avoidance, and tax planning will be presented. It is also necessary to provide a background of both the main scheme of VAT and the reverse charge mechanism.

The main questions in this thesis to be answered are; is the reverse charge an efficient method to combat VAT fraud problem in a specific sector, in this thesis the construction sector? What are the effects of the reverse charge mechanism? If the reverse charge mechanism is an efficient method to combat tax fraud, are the negative effects of it proportionate to the goal; to combat tax fraud?

This thesis is directed to readers with a basic or good knowledge about the VAT system and legislation within the EU. The thesis provides a background of both the main VAT scheme and the reverse charge scheme so readers with basic knowledge can easily follow as well.

## **1.3 Method and material**

This thesis is based on a legal study. The first part of the thesis is descriptive and the second part consists of an analysis.

Material used are EC legislation, primary and secondary and case law from the European Court of Justice (the ECJ), Swedish VAT legislation, articles and doctrine. Also the website of the Swedish Construction Federation is used where suitable.

## **1.4 Disposition**

After the introductory chapter, chapter 2 discusses the debated terms of tax evasion, tax avoidance and tax planning for the purpose of giving all readers the same understanding of the writer's wording about 'tax fraud'. Chapter 3 introduces the general legislation relevant to this thesis. Chapter 4 gives an overview of the construction sector in Sweden as well as the tax

fraud problem in that sector. The scheme of tax fraud is presented. Chapter 5 looks at the reverse charge mechanism. Its background and conditions for application are presented. Chapter 6 evaluates the effects of the reverse charge mechanism and chapter 7 presents other techniques that can be used for decreasing tax fraud. The final chapter contains an analysis and conclusions and an attempt to answer the stated questions of the thesis.

## 1.5 Delimitations

The reverse charge mechanism is used differently in different Member states and to varying extents.<sup>14</sup> To be able to make examples and highlight the reverse charge as a derogation system, the writer has chosen to focus on reverse charge mechanism in the construction sector in Sweden, when it is not examined as a general method in a specific sector. This has to be distinguished from reverse charge mechanism used as a general method in all sectors of a Member state.

Concerning the chapter defining the terms of tax evasion, tax avoidance and tax planning, a limited number of articles and doctrine are used, since the definition dilemma is not the main subject of this thesis. This is complemented with case law from the European Court of Justice (the ECJ).

In chapters where legislation is presented for the reason to give a background to either a problem or the legislation, the writer has limited the presentation to a more detailed account of only service supply legislation. Other presentations are also limited to the scope of this thesis topic.

It would have been enlightening to have the economic perspective of the efficiency of the reverse charge mechanism in this thesis. This will unfortunately not be provided, primarily because the writer's background is foremost legal, secondly because of the limited space.

At the moment, carousel VAT fraud is a huge problem in the European Union. Carousel VAT fraud is not examined in this thesis, however both the problem as such and techniques to solve the problem are used analogically where it is suitable.<sup>15</sup>

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<sup>14</sup> See chapter 5, the procedure and to what extent the reverse charge mechanism can be introduced in a Member state.

<sup>15</sup> Carousel VAT fraud arises with cross-border transactions within the EU. Those transactions are VAT-free. A seller buys goods or services without paying VAT. Then the seller charges VAT on the sale of the goods or services. Instead of paying the VAT to the tax authorities, the seller simply disappears, with the VAT. The buyer then claims a refund of VAT paid to the so-called 'missing trader'. Consequently, state financial loss is a fact. The difference with this thesis examination is foremost that there is no cross-border element. The VAT fraud examined in this thesis arises from domestic transactions where the output VAT is not paid, but there is no VAT-free transaction in the chain as in a cross-border transaction between Member states.

## 2 Tax evasion, tax avoidance and tax planning

The concepts of tax evasion, tax avoidance and tax planning cover a sort of behaviour directed to minimize tax burdens. It is important to establish the differences between tax evasion, tax avoidance and tax planning in order to draw a line between what is legal and acceptable and what is illegal and unacceptable. Furthermore, it would be perplex to use one term to cover different phenomena.<sup>16</sup>

The Commission is of the opinion that tax systems should continue to lie within the competence of the Member states. On the other hand, the Commission emphasises a more common and coordinated approach, to help the Member states to fight tax fraud. A more common and coordinated approach would assist the Member states in knowing what behaviour to fight.<sup>17</sup>

Since the majority of Member states recognize the right of the taxpayer to organize his affairs in a way, which attracts minimum tax liability, the margin is far from clear in this field.<sup>18</sup> The result is that these terms are debated. Highly debated are the (potential) boundaries between tax evasion, tax avoidance and tax planning. The purpose of this chapter is to give all readers the same standing concerning these debated terms for the rationale of this thesis.<sup>19</sup>

### 2.1 Tax evasion

Tax evasion is an essentially illegal activity that is subject to criminal sanctions. Tax liability exists and there are sanctions in place.<sup>20</sup> The taxpayer's failure to correctly declare the right amount of calculable income is the illegal transaction; a direct violation of a tax provision is required. The result that the tax is not paid is illegal. Examples of tax evasion are money laundering and money smuggling.<sup>21</sup>

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<sup>16</sup> Merks, Paulus, 'Tax Evasion, Tax Avoidance and Tax Planning' p. 1 and 4

<sup>17</sup> Merks, p. 6. The European Commission on 26 October 2005 released a provisional communication outlining anticipated tax policy reform measures to improve the EU Single market.

<sup>18</sup> Merks, p. 1

<sup>19</sup> The writer is aware that attempts to find clear boundaries between tax evasion, tax avoidance and tax planning are made frequently in the doctrine and that there are no clear lines between these terms. For the purpose of this thesis the writer will define the terms. The main purpose of the thesis is not the establishment of the terms but it is of importance that it is clear what the writer means when using the terms.

<sup>20</sup> Merks, p. 5

<sup>21</sup> Merks, p. 2

Tax evasion is where ‘the taxpayer avoids the payment of tax without avoiding the tax liability, consequently escapes the payment of tax and even breaks the letter of the law’.<sup>22</sup> This definition is widely adopted by Member states in the EU.<sup>23</sup>

## 2.2 Tax avoidance

Tax avoidance is seen as a less serious illegal action than tax evasion. Tax avoidance is for example omissions in the form of failure to submit complete returns of income and more serious offences such as false declarations or false invoices. Furthermore, tax avoidance requires an action taken by the taxpayer. Tax avoidance covers only those forms of tax minimization that are unacceptable to governments.<sup>24</sup>

Characteristic for tax avoidance is an explicit objective for the taxpayer to evade taxes. Most Member states provide criminal sanctions in tax avoidance situations; the intention of the taxpayer is dealt with on a regular basis in the Member states national legislation. However, the complexity of the identification of tax avoidance is that both the definition and the consequences of it vary from country to country.<sup>25</sup>

In a report from the Organisation for Economic Co-operation and Development (OECD) in 1987, the report on International Tax Avoidance and Evasion,<sup>26</sup> four elements of tax avoidance were presented. The first element is that the transaction almost always is dishonest; arrangements are planned according to systems, which themselves are not primarily for business or economic purposes. The second element is that it may be confidential. The third element of tax avoidance is that it takes advantage of loopholes in the law or the applying legal provisions for a purpose that is not intended.<sup>27</sup> Lastly, the fourth element is that the major benefit from the transaction is obtaining a tax benefit.<sup>28</sup> These elements are in principle the same as those in the evaluation of which transactions constitute an abusive practice.<sup>29</sup>

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<sup>22</sup> Merks, p. 2

<sup>23</sup> Merks, p. 2 This definition is not shared by all Member states, see Uckmar.

<sup>24</sup> Merks, p. 2

<sup>25</sup> Merks, p. 2 Writers comment; maybe the ratification of the Lisbon Treaty will contribute to a more harmonious penalty establishment among the Member states, when also the Third Pillar will become supranational.

<sup>26</sup> International Tax Avoidance and Evasion, Four related studies, Paris 1987, (the Report).

<sup>27</sup> Merks, p. 2 It is argued that the report is unreliable since it constitutes some uncertainties, such as ‘almost’ and ‘may’. Lastly in the report, it is stated that an aforementioned definition of tax avoidance is unclear.

<sup>28</sup> Merks, p. 2-3

<sup>29</sup> Norberg, Karin and Franciska Pettersén. Förfarandemissbruk inom mervärdesskatteområdet, Skattenytt 2008 nr 1. (Abusive practice in the area of VAT), p. 6. Norberg and Pettersén state that four elements have to be fulfilled for a transaction to constitute abusive practice according to the principle of abusive practice; the transaction

The ECJ stated in the ICI-case<sup>30</sup> that tax avoidance is ‘a wholly artificial arrangement, set up to circumvent legislation’.<sup>31</sup> In the Marks & Spencer-case<sup>32</sup>, the ECJ, especially concerning the risk of tax avoidance, stated that ‘it must be accepted that the possibility of transferring the losses incurred by a non-resident company to a resident company entails the risk that within a group of companies losses will be transferred to companies established in the Member states which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest’. The ECJ also stated in the judgement that Member states are free to adopt or maintain rules that have the purpose of preventing ‘wholly artificial’ actions which are set up to evade tax liability.<sup>33</sup> Thus, in the Marks & Spencer-case the ECJ recognized the need for rules preventing tax avoidance, but ruled that the rules for preventing tax avoidance went beyond what was necessary to obtain the objectives in this case.<sup>34</sup>

## 2.3 Tax planning

Tax planning is a legal action taken by the taxpayer to reduce a tax burden and does not constitute a crime. The behaviour of the taxpayer is legal, because Member states in general recognize the right of a taxpayer to arrange his affairs to pay less tax.<sup>35</sup> There is no tax liability and no sanctions and the legislator disregards it, since it is irrelevant for tax purposes.<sup>36</sup>

### 2.3.1 Concluding remarks; Tax evasion, tax avoidance and tax planning

From the above, it can be concluded that tax evasion is illegal and that tax avoidance raises questions as to whether it is legal or illegal, since the difference in criminalization differs among the Member states and therefore consequently constitutes the largest problem. Further, tax planning is legal. No clear line can be drawn but what is distinguishing for each term is summarized here.

Tax evasion is an illegal action and is subject to criminal sanctions. A direct violation of a tax provision is essential.

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has to provide a service or goods, it has to give a tax benefit, which infringes the VAT directive and the main purpose has to be to get a tax benefit.

<sup>30</sup> ICI-case, C-264/96

<sup>31</sup> ICI-case, C-264/96, para 26

<sup>32</sup> Mark & Spencer-case, C-446/03

<sup>33</sup> Mark & Spencer-case, C-446/03, para 57

<sup>34</sup> Mark & Spencer-case, C-446/03, para 47 and 48

<sup>35</sup> Merks, p. 2

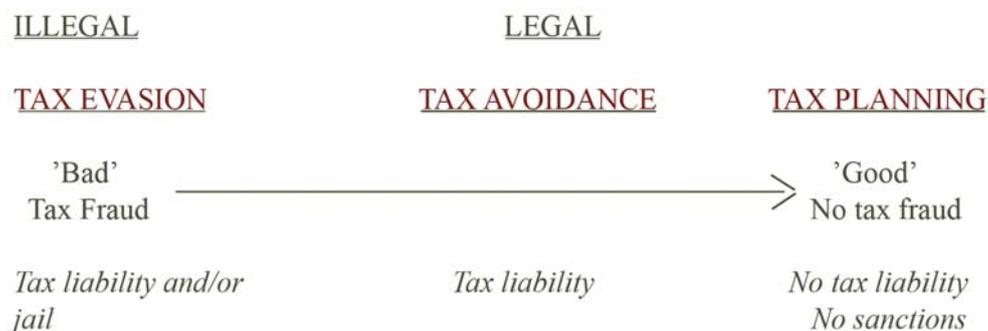
<sup>36</sup> Merks, p. 5

Tax avoidance is the most uncertain term. Most Member states provide criminal sanctions, which can be one of the problems. If all Member states criminalized the same action, it would be easier to draw a line as to whether it is legal or illegal. The objective is to evade tax; an assessment of intent of the taxpayer needs to be done. The OECD report stated four provisions that have to be fulfilled to constitute tax avoidance; dishonesty, confidentiality, abuse of loopholes in the law and that the major benefit of the transaction is obtained from the tax benefit.<sup>37</sup> Moreover, the ECJ states that tax avoidance is when ‘wholly artificial’ arrangements are made, which is in accordance with four conditions from the OECD report in the writer’s opinion.

Tax planning is a legal action to minimize the tax burden. There is no tax liability and no criminal sanction.

In the following thesis, tax evasion and tax avoidance are treated as illegal actions and tax planning as a legal action. Tax evasion and tax avoidance will be called ‘tax fraud’ in the following thesis. Where the term tax fraud is used, tax evasion and tax avoidance are both included in order to assist the reader.<sup>38</sup>

This picture helps to illustrate the boundaries, or attempted boundaries, between the terms of tax evasion, tax avoidance and tax planning.<sup>39</sup>



<sup>37</sup> Norberg and Pettersén state the same conditions to be fulfilled to constitute a transaction in the meaning of an abusive practice.

<sup>38</sup> The writer is aware that different phenomena shall be treated differently, see chapter 2. But for the rationale of this thesis, the purpose of which is not to investigate, just highlight, the debate of the boundaries between those terms for the purpose of facilitating the following description.

<sup>39</sup> The original picture, see Merks, p. 4

# 3 Legislation

This chapter presents the legislation, which is of relevance for this thesis. It starts with the general provision of the Consolidated Version of the Treaty Establishing the European Community (the EC Treaty). Thereafter the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (the VAT directive). The writer limits the general introduction of the VAT system to merely a background of the scheme, so that the reader can follow the thesis's examination of the reverse charge mechanism more easily.

## 3.1 The EC Treaty

This chapter aims to give a short background to the principles of the European Community (the EC). The general aims and principles of the EC are helpful also to understand the VAT legislation and the preventive measure taken or not taken by the legislator to combat the VAT fraud.<sup>40</sup>

### 3.1.1 General provisions

The EC has as mission, among others, to uphold a harmonious, balanced and sustainable development of economic activities, a high degree of competitiveness and convergence of economic performance and economic and social coherence between the Member states.<sup>41</sup> To obtain these goals the EC shall work for a common commercial policy,<sup>42</sup> abolish obstacles between the Member states to achieve free movement of goods, persons, services and capital,<sup>43</sup> a system ensuring that competition in the internal market is not distorted,<sup>44</sup> approximation of the laws in the Member states to the extent required for the functioning of the internal market,<sup>45</sup> and a strengthening of the economic and social cohesion.<sup>46</sup>

Member states have to fulfil their obligations arising from the EC Treaty<sup>47</sup> to facilitate the EC's tasks. The EC shall act within the limits of its powers awarded from the EC Treaty<sup>48</sup> and shall only act insofar as the objectives

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<sup>40</sup> The writer has chosen to present the general provisions that are of relevance for this thesis.

<sup>41</sup> EC Treaty art 2. The writer deliberately limits the missions of the EC to economic once in art 2 of the EC Treaty, for the purpose of this thesis.

<sup>42</sup> EC Treaty art 3(1)(b)

<sup>43</sup> EC Treaty art 3(1)(c)

<sup>44</sup> EC Treaty art 3(1)(g)

<sup>45</sup> EC Treaty art 3(1)(h)

<sup>46</sup> EC Treaty art 3(1)(k)

<sup>47</sup> Principle of Loyalty, EC Treaty art 10

<sup>48</sup> Principle of Proportionality, EC Treaty art 5(1)

of the proposed action cannot be sufficiently achieved by the Member state and can be better accomplished by the EC.<sup>49</sup>

### **3.1.2 Financial and tax provisions**

Both the Member states and the EC shall take measures that act as a deterrent and afford effective protection within the Member states against financial fraud and illegal activities that affect the financial interests of the EC. The Member states have an obligation to take measures to counter fraud, which affects the financial interests of the EC. For the aim of protecting the financial interests of the EC, the Member states shall coordinate their actions to combat the fraud. There shall be a close and regular cooperation between the competent authorities of the Member states and the Commission.<sup>50</sup>

Member states are prohibited to impose, directly or indirectly, internal taxation on products from other Member states, which are similar to domestic products. Member states are also prohibited to impose any internal taxation of the nature as to afford indirect protection to other products, on products of another Member state.<sup>51</sup>

Harmonisation of legislation on indirect taxes is done to the extent necessary to ensure the establishment and the functioning of the internal market. The Council acts unanimously on proposals from the Commission, after consulting the European Parliament (the Parliament) and the Economic and Social Committee.<sup>52</sup>

## **3.2 The VAT directive**

To some extent, this presentation is limited to present provisions concerning only supply of services and thus in more detail. The writer makes the selection.

### **3.2.1 The general scheme of VAT**

The VAT directive establishes a common system of VAT in the EU.<sup>53</sup> This principle of a common VAT system entails the applications of a

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<sup>49</sup> Principle of Subsidiary, EC Treaty art 5(2)

<sup>50</sup> EC Treaty art 280 It is the Council who acts within an art 251 procedure to adopt necessary measures to prevent and fight against fraud which affects the financial interests of the Community.

<sup>51</sup> EC Treaty art 90 Writers comment: Non-discrimination clause specific for taxation. See also chapter 2.2 about the ECJs judgement in the Marks & Spencer-case, allowing Member states to introduce legislation to prevent 'wholly artificial arrangements'.

<sup>52</sup> EC Treaty art 93

<sup>53</sup> VAT directive art 1(1)

general tax on consumption of goods and services that is exactly proportionate to the price of those goods and services.<sup>54</sup> VAT is calculated on each transaction, estimated on the price of the goods or services and shall be charged<sup>55</sup> after deduction of the amount of VAT born directly by the various cost components. The VAT scheme is applied up to and including the retail trade stage.<sup>56</sup>

The supply of goods and services for consideration within the territory of a Member state by a taxable person,<sup>57</sup> the intra-Community acquisition of goods for consideration within the territory of a Member state<sup>58</sup> and the importation of goods are taxable transactions subject to VAT.<sup>59</sup> The directive thus exempts certain transactions from VAT.<sup>60</sup>

When the legal conditions necessary for VAT are fulfilled the event is chargeable, it is a 'chargeable event'.<sup>61</sup>

A 'taxable person' is any person who independently<sup>62</sup> carries out, in any place, any economic activity, whatever the purpose or results of that activity is.<sup>63</sup> Persons liable for the payment to the tax authorities are any taxable persons who carry out a taxable supply of goods or services.<sup>64</sup> Member states may provide that the taxable person, to whom the supplies are made, is the person liable for the payment of VAT to the tax authorities.<sup>65</sup> The preamble to the VAT directive states that it is proper to specify persons liable for the payment of VAT, especially when it concerns services supplied by a person who is not established in the Member state in which the VAT is due.<sup>66</sup> Further, the preamble to the VAT directive states that the Member states should be competent, in

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<sup>54</sup> VAT directive art 1(2) 'Supply of services' shall mean any transaction which does not constitute a supply of goods, VAT directive art 24

<sup>55</sup> VAT directive art 62(1). Events are chargeable when the tax authorities are entitled under law, at a particular moment, to claim the tax from the person liable to pay, even though the time of payment may be deferred, VAT directive art 62(2).

<sup>56</sup> VAT directive art 1(3) and (4)

<sup>57</sup> VAT directive art 2(a) and (c)

<sup>58</sup> VAT directive art 2(b)

<sup>59</sup> VAT directive art 2(d)

<sup>60</sup> VAT directive art 3, 4 and 131 to 153, (Title IX, Chapter 1 to 9)

<sup>61</sup> VAT directive art 62(1)

<sup>62</sup> The word 'independently' exclude employed and other persons from VAT in as so far as they are bound to an employer by a contract of employment or by any other legal ties creating the relationship of employer and employee as regards working conditions, remuneration and the employer's liability, VAT directive art 10

<sup>63</sup> VAT directive art 9

<sup>64</sup> VAT directive art 193. Derogations from this can be found in articles 194 to 199 and article 202. Only art 199 is presented further for the purpose of this thesis.

<sup>65</sup> VAT directive art 199. Art 199(1)(a) is the legal base for the reverse charge mechanism in the construction sector in Sweden. Construction work also includes repair, cleaning, maintenance, alteration and demolition services in relation to immovable property, the handing over of construction work is regarded as a supply of goods pursuant to art 14(3). See more chapter 5

<sup>66</sup> VAT directive recital 41

certain cases, to appoint the recipient of supplies of goods or services as the person liable for payment of VAT. This assists Member states to simplify the rules and counter tax evasion and avoidance in identified sectors and on certain types of transactions.<sup>67</sup> Moreover, the preamble emphasises that harmonisation of the obligations for the taxable persons is necessary to safeguard the collection of VAT in a consistent manner in the Member states.<sup>68</sup>

For the purpose of avoiding double taxation on taxable transactions, the general rule for the place of supply of services is deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied. If there is a lack of such a place of business or fixed establishment, the place shall be where the supplier has his permanent address or usually resides.<sup>69</sup> Supply of services connected with immovable property shall be the place where the property is located.<sup>70</sup>

The taxable amount for the purpose of the VAT directive is the 'open market value'.<sup>71</sup> When it concerns services the taxable amount shall be the full cost to the taxable person of providing the services.<sup>72</sup>

The rate of VAT shall be a standard rate in the Member states. Each Member state shall have a fixed rate as a percentage of the taxable amount and it shall be the same for the supply of goods and the supply of services.<sup>73</sup>

When the tax becomes chargeable, the right to deduct arises.<sup>74</sup> Furthermore, taxable persons which are established in another Member state than the state from which they purchase goods or services, or import goods subject to VAT, shall be entitled to obtain a refund of the VAT, when the tax is paid solely by the customer in accordance with art 199.<sup>75</sup>

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<sup>67</sup> VAT directive recital 42

<sup>68</sup> VAT directive recital 45

<sup>69</sup> VAT directive art 43

<sup>70</sup> VAT directive art 45. The VAT directive does not define immovable property. Member states are free to define the concept of immovable property themselves, which also can create inequalities between the Member states. Andersen, Author; Netherlands Study for The Commission on the Application of VAT and Other Indirect Taxes to the Property sector, p. 3 and 19

<sup>71</sup> VAT directive art 72. The open market value is the full amount in order to obtain the goods or services, which a customer at the same marketing stage where the supply of goods or services takes place would have to pay under conditions of fair competitions, to a supplier at arm's length within the territory of the Member state in which the supply is subject to tax.

<sup>72</sup> VAT directive art 75

<sup>73</sup> VAT directive art 96

<sup>74</sup> VAT directive art 167, (Title X, Chapter 1) The right to deduct is entitled to the taxable person as long as the goods or services are used for the purposes of the taxed transaction, art 168 VAT directive. Art 168 and 169 states the costs to deductible from VAT.

<sup>75</sup> VAT directive art 170. Also articles 169 and 194 to 197. Art 171 also comprises situations when VAT shall be refunded.



# 4 The construction sector in Sweden

## 4.1 Introduction

The construction sector in Sweden consists of nearly 80 000 companies. 97 percent of these companies have less than 20 employees. A future proprietor is usually responsible for the projects and also the investments. The future proprietor is also in charge of ensuring that the project is done according to plan and according to environmental issues. Generally, the future proprietor is a supplier but also demands supply from other suppliers. The same company can be the principal and at the same time the consultant towards another company, which is then a sub-contractor.<sup>76</sup>

In 2000 and 2001 the National Tax Board<sup>77</sup> in Sweden made a national investigation into the construction sector for the purpose of finding a solution to the problem of workers for whom the employees do not pay tax and tax fraud chaos.<sup>78</sup> The National Tax Board considered that organized trade with artificial arrangements had increased to such an extent that radical amendments to the legislation were needed. The basis of the investigation was that the value of the fraud was estimated as being between 2 - 2,5 billion Swedish crowns yearly.<sup>79</sup> The Swedish tax authorities concluded in its memorandum in 2005, based on a review of the law made between 1995 and 2003, that the construction sector was one of the sectors in which the problem was most extensive.<sup>80</sup>

Tax fraud is arranged with different structures with detached representatives for the sole purpose of complicating the uncovering of artificial chains for the tax authorities. Examples of consultants used are sub-contractors, manpower companies and agents. The investigation showed that the sub-contractors usually perform the tax fraud.<sup>81</sup> The tax fraud scheme is used for the sole purpose of not paying VAT or other taxes.<sup>82</sup>

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<sup>76</sup> Prop. 2005/06:130, p. 14 This chain is illustrated in chapter 1.1 and also in chapter 4.2.

<sup>77</sup> In Swedish; Riksskatteverket

<sup>78</sup> In Swedish 'bygghärvor'. Prop. 2005/06:130, p. 18

<sup>79</sup> Prop. 2005/06:130, p. 18

<sup>80</sup> Skatteekonomiska meddelanden, nr 47 av den 7 oktober 2005. It should be kept in mind that tax fraud does not only exist in the construction sector. Nor are these problems specific to Sweden.

<sup>81</sup> Prop. 2005/06:130, p. 20

<sup>82</sup> Prop. 2005/06:130, p. 19

## 4.2 The scheme of tax fraud

One scheme of tax fraud is when a construction company, the principal, has commissioned a project to a consultant for the sole purpose of making false invoices. Usually the consultant issues the false invoices. There is usually no intention for the invoices to be paid. It seems like manpower is hired, but de facto the manpower is employed by the principal. Typically in this scheme of tax fraud, the companies issue invoices to a series of consultants. These companies, which often are placed at the third and fourth stage of the contractor-chain, often exist for a very short period of time and disappear if the tax authorities want to control them. Nonetheless, the principal immediately hires new manpower, which continues to send false invoices. In practice, this means that when the tax authorities acquire knowledge about the artificial transaction, the principals have already let the activity to another consultant, and so the taxes and fees are never paid.<sup>83</sup> This scheme of tax fraud involves a series of transactions with the purpose of gaining a VAT advantage either by lowering the final VAT charge or by increasing the refund of VAT. The artificial nature of the chain of transactions is the most distinguishing feature of the scheme.<sup>84</sup> It is confirmed that companies are established only for the purpose of issuing false invoices.<sup>85</sup>

This scheme of tax fraud is illustrated below.<sup>86</sup>

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<sup>83</sup> Prop. 2005/06:130, p. 20

<sup>84</sup> COM(2005) 89 final, p. 2

<sup>85</sup> Prop. 2005/06:130, p. 20

<sup>86</sup> The writer does the sketch map based on the facts in Prop. 2005/06:130 p, 16.

1. Customer. Pays 1 000 000' whence 250 000' is VAT (in this case the reverse charge is not applicable since the customer is not a construction company).

= The green area represents the artificial arrangement sector. It is in this sector where the tax fraud is being committed, conveying a VAT loss

**Contractors and sub-contractors**

		<b>INPUT VAT</b>	<b>OUTPUT VAT</b>	<b>VAT to the tax-authorities</b>
2. Principal, only contract with the consultant		↑ 25 000'	250 000'	
Invoice: Services	100 000'			
VAT	25 000'			
Σ	125 000'			250 000' - 25 000' = 225 000'
3. Consultant and sub-contractor		↑ 2 500'	25 000'	
Invoice: Services	10 000'			
VAT	2 500'			
Σ	1 250'			25 000' - 2 500' = 22 500'
4. Sub-contractors (carpenters, cleaners and assemblers)		↑ 250'	2 500'	
Invoice: Services	1 000'			
VAT	250'			
Σ	1 250'			2 500' - 250' = - 250'
5. Sub-contractors (manpower)		↑ 25'	250'	
Invoice: Services	100'			
VAT	25'			
Σ	125'			250' - 25' = - 25'
6. Sub-contractors (manpower)		↑	25'	
VAT loss → 250' + 25' + 2 500' + 250' = 3 025'				

The consequence of the artificial arrangements is that even though the VAT is debited and collected, the VAT is never paid to the tax authorities. The company neglects both to pay and present the VAT it has collected from its customer. De facto, it is a neglect of output VAT.<sup>87</sup>

<sup>87</sup> Prop. 2005/06:130, p. 20. See chapter 1, the sketch of the main VAT collection. The consequences of VAT fraud is stated in chapter 1.1

# 5 The reverse charge mechanism

On the 1st of July 2007, Sweden introduced the reverse charge mechanism in the construction sector with art 199 (a) of the VAT directive as a legal base.<sup>88</sup> The main rule is that a taxable person who carries out a taxable supply of goods or services is liable for the payment of VAT to the tax authorities. Derogation is when the consumer is liable for the payment of VAT to the tax authorities; reverse charge mechanism.<sup>89</sup>

The VAT directive was implemented in 2007. Before the amendment of the VAT directive, Member states had to be authorised by the Council, according to art 27 in directive 77/388/EEC (now art 395 in the VAT directive), to introduce special schemes as the reverse charge mechanism, for the purpose to combat tax fraud. Sweden requested authorisation for implementing the reverse charge mechanism, but through the amendment authorisation was not needed. In the VAT directive, the most frequently requested special schemes under art 27 in dir 77/388/EEC are approved in advanced by the Council and may be introduced by Member states to combat tax fraud without specific authorisation. These schemes are stated in art 199 in the VAT directive.<sup>90</sup>

## 5.1 Background

Art 199 in the VAT directive provides derogations when the taxable person to whom the goods or services are supplied is the person liable for the payment of VAT to the tax authorities.<sup>91</sup> Member states do not need to inform the Council if they want to introduce a derogation provided in art 199. If a Member state wishes to introduce a scheme, which is not authorised by the Council prior to the 13 of August 2006 in accordance with art 27 (1) to (4) of Directive 77/388/EEC, it has to inform the VAT Committee.<sup>92</sup> The procedure for authorisation is, after the amendment of directive 77/388/EEC, given in art 395 in the VAT directive. The derogations in art 199 have already been subject to the procedure in art 394 and 395 in the VAT directive (before art 27) and therefore the reasoning and background of these are of interest for the thesis.

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<sup>88</sup> Skattehandlingsboken 2008 p 674 (Book of Tax guidance 2008)

<sup>89</sup> VAT directive art 199(1)(a). See also chapter 1.1 the scheme of the reverse charge mechanism and 3.2.1 the general provisions of the VAT system.

<sup>90</sup> Renström, Staffan. 'Mervärdesskatt – omvänd skattskyldighet mellan byggföretag' Skattenytt 2007 nr 3 (VAT - Reverse charge mechanism in the construction sector) (Tax News 2007 no 3), p. 2

<sup>91</sup> Art 194 to 198 in the VAT directive also provide situations where the taxable person is the one to whom the services or goods are supplied.

<sup>92</sup> VAT directive art 199(4)

### **5.1.1 Article 394 and article 395; simplification measures and measures to prevent tax evasion or tax avoidance**

Article 394 in the VAT directive allows Member states to retain special methods to simplify the process for collecting the VAT or to prevent certain forms of tax evasion or tax avoidance, provided that they have notified the Commission and that the simplification measures comply with art 395 (1).

Article 395 (1) states that in order to simplify the procedure for collecting VAT or to prevent certain forms of tax evasion or tax avoidance, the Council may authorise any Member state, on a proposal from the Commission, to introduce special measures for derogation from the provisions of the VAT directive. Those measures may not, except to an insignificant degree, affect the overall amount of the tax revenue of the Member state collected at the stage of final consumption.<sup>93</sup>

#### **5.1.1.1 The amendment of art 27; aim and purpose of art 395**

The Commission emphasised, in its communication to the Council and the Parliament on the 7<sup>th</sup> of June 2000<sup>94</sup> and in communication on the 20<sup>th</sup> of October 2003<sup>95</sup>, the importance of rationalising and improving some of the large number of derogations under art 27 (now art 395), and developing the process of the VAT system within the context of the internal market.<sup>96</sup>

An objective of the proposal was to reduce the number of derogations, most particularly where there is duplication between the Member states.<sup>97</sup> The Commission was of the opinion that specific schemes should be permanently workable alternatives to the standard treatment, where they can be justified through evidence of tax evasion or avoidance, rather than being temporary derogations.<sup>98</sup> Such a rationalization would make certain individual derogations accessible to all Member states by an amendment of the VAT directive.<sup>99</sup> Those derogations would be those that have already proved themselves to be effective, and which tackle problems that are shared by more than one Member state.<sup>100</sup> Further, it should be those

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<sup>93</sup> VAT directive art 395(1)

<sup>94</sup> COM(2000) 348 final

<sup>95</sup> COM(2003) 614 final

<sup>96</sup> COM(2003) 614 final, p. 3

<sup>97</sup> The directive also formally annuls a number of Council decision, COM(2005)89 final, p. 4

<sup>98</sup> COM(2005) 89 final. Writers comment; as art 199 in the VAT directive provide

<sup>99</sup> 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

<sup>100</sup> COM(2005) 89 final

schemes that are best suited to a common VAT procedure on the internal market.<sup>101</sup>

The proposed changes showed the need for limited flexibility under art 27 in general.<sup>102</sup> A common characteristic of the derogations are that they represent an alternative to the normal rules and are only made available to all Member states in order to help combat tax evasion and avoidance and to simplify the collection of tax.<sup>103</sup>

Another purpose of the amendment was to increase transparency. Under the procedure in art 27 in directive 77/388/EEC the Commission had to respond to every request for alternative schemes submitted by a Member state by presenting a proposal to the Council, deciding whether the measure was suitable or not.<sup>104</sup>

The proposal allowed Member states to adopt alternative rules,<sup>105</sup> with the target of solving specific national problems. Member states are authorised to limit the application of an alternative rule at a national level in order to combat the specific evasion or avoid problems in that Member state.<sup>106</sup> It also means that the measure taken to combat VAT fraud has to be proportional to the problem.<sup>107</sup> The Member state shall profit from an alternative and selective rule, rather than a general and extensive rule, which affects tax fraudsters and not business in general.<sup>108</sup>

The reverse charge mechanism is to be used in sectors where it is proved exceptionally difficult for Member states to supervise. The difficulty to supervise in that sector can depend on the structure of the industry or the nature of it.<sup>109</sup> Services covered in this are services relating to buildings (including any, or all, of the services of construction, repair, cleaning and demolition); supplies of staff relating to building services; land and buildings on which the option to the tax has been exercised; and supplies of waste, scrap and recyclable material together with some products resulting from their treatment and some treatment services.<sup>110</sup>

The reverse charge mechanism has the result of being more efficient and facilitates tax collection, with no influence on tax terms for the customer and with minimal additional fulfilment costs.<sup>111</sup>

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<sup>101</sup> COM(2003) 614 final, p. 3

<sup>102</sup> COM(2005) 89 final, p. 3

<sup>103</sup> COM(2005) 89 final, p. 3

<sup>104</sup> COM(2005) 89 final, p. 4

<sup>105</sup> There is no obligation for a Member state to adopt the rule if there is no need for such a rule in the national legislation, COM(2005) 89 final, p. 3

<sup>106</sup> COM(2005) 89 final, p. 4

<sup>107</sup> Prop 2005/06:130: p. 47

<sup>108</sup> COM(2005) 89 final, p. 4

<sup>109</sup> COM(2005) 89 final, p. 8

<sup>110</sup> COM(2005) 89 final, p. 8

<sup>111</sup> COM(2005) 89 final, p. 8

## 5.2 Conditions for application of the reverse charge mechanism in the construction sector

The reverse charge mechanism in the construction sector shall be applied when three conditions are fulfilled. Firstly, the services have to be services of construction work, including cleaning, maintenance, repair, alteration and demolition relation to immovable property. Handing over the construction of works is regarded as a supply of goods pursuant to art 1 and 2.<sup>112</sup> Secondly, the buyer also has to, on an occasional basis, carry out these services or be a vendor of the actual service.<sup>113</sup> Thirdly, the services have to be supplied within the country, Sweden.<sup>114</sup>

The legislation is compulsory; the reverse charge is to be applied if these conditions are fulfilled, irrespective of whether the seller has a Swedish or a foreign establishment.<sup>115</sup> This is for the purpose of equal treatment and to complicate to setting up of artificial companies abroad to escape the reverse charge mechanism.<sup>116</sup> When the conditions are fulfilled the invoice shall be sent to the buyer without VAT.<sup>117</sup>

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<sup>112</sup> ML 1:2 2 paragraph (1), (2) and (3)

<sup>113</sup> ML 1:2 4b

<sup>114</sup> ML 1:1 paragraph 1 See more about the place of supply, Omsättningskravet in ML 5:4

<sup>115</sup> SKV:s skrivelse, p. 20

<sup>116</sup> Prop. 2005/06:130, p 47

<sup>117</sup> SKV:s skrivelse, p. 20

# 6 Effects of reverse charge mechanism

The reverse charge mechanism was subject to criticism even before it was introduced in the construction sector. The fact that the reverse charge mechanism is a derogation system forces the construction sector to apply a new system, which is fundamentally different from the main scheme of VAT.<sup>118</sup>

## 6.1 Negative effects

It has been argued that that problems with sub-contractors and loss of output VAT in the chains have been replaced with new difficulties and that the reverse charge mechanism only makes it even harder to control transactions in the contractor chain. It has also been argued that the legislators made presumptions, which are incorrect or are too restricted or too unclear.<sup>119</sup> These problems will be presented below.

### 6.1.1 Definition problems

After the introduction of the reverse charge mechanism in 2007, several interpretation problems with the legislation arose.<sup>120</sup> The services within the scope of the reverse charge mechanism were decided with SNI 2002 as a base. On the 1st of January the binding character of SNI 2002 was abolished.<sup>121</sup> The services within the scope of reverse charge mechanism are now to be decided by the general meaning of the terms.<sup>122</sup> SNI 2002 is thus used as a guide when deciding if a service is within the scope of the application of the reverse charge mechanism.<sup>123</sup> It was stated in the government bill that the reverse charge mechanism should have a wide scope of application in the construction sector.<sup>124</sup>

The supplier of the services has to decide if the provisions for the reverse charge mechanism are fulfilled. This means that the supplier has to decide

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<sup>118</sup> Prop 2005/06:130, p. 61

<sup>119</sup> Forssén, Björn; Omvänd skattskyldighet inom byggsektorn – Skapar den flera momsproblem än den löser?(Reverse charge in the construction sector – does it create more problems than it solves?), p. 2

<sup>120</sup> Skatteverkets skrivelse, p. 2

<sup>121</sup> Skatteverkets skrivelse, p. 41

<sup>122</sup> Proposition 2007/08:25 Förlängd redovisningsplikt och andra mervärdessattefrågor (Government bill 2007/08:25 (Extended time for account duty and other VAT questions) (Prop 2007/08:25)

<sup>123</sup> Skatteverkets skrivelse, p. 41

<sup>124</sup> Prop 2005/06:130, p. 46

if the service provided is a service, within the scope of the reverse charge mechanism. Further, it means that the supplier has to decide if the buyer of the service is a buyer with the status of a construction company within the reverse charge mechanism application.<sup>125</sup>

### **6.1.1.1 If the buyer is a construction company**

The uncertainty concerning which companies shall be charged VAT and which shall not, is a difficulty with the reverse charge mechanism.<sup>126</sup>

The supplier has to verify the status of the buyer since the reverse charge mechanism only applies to buyers, which are construction companies. The supplier of the service is responsible for the invoice, even when the customer is liable for the payment of VAT to the tax authorities. The invoice must contain the VAT registration number of the buyer and information that the buyer is liable for the payment of VAT.<sup>127</sup> If the supplier is uncertain as to whether the customer is a construction company for the application of the reverse charge mechanism, the supplier shall obtain information about the customer's status. The best way of obtaining the information is from the buyer himself. If the tax authorities carry out a control and ask why a VAT is charged wrongfully (if it is), one would be encouraged to have an adequate answer.<sup>128</sup>

Because of the non-satisfactory guidance from the legislator in this respect the Swedish Construction Federation<sup>129</sup> together with consultant firms<sup>130</sup> has created a form, which is to be sent from the supplier to the buyer to fill in information needed to facilitate the procedure.<sup>131</sup> Also when a customer's status is identified, it can be difficult to keep up with possible changes of it.<sup>132</sup>

#### **6.1.1.1.1 Losing the right to deduct and the risk of additional fees**

Construction companies must take into account various considerations and practical issues that can arise in the course of their implementation. If VAT is wrongfully charged on an invoice, where the reverse charge mechanism was to be applied, that VAT is not deductible for the assigner. The wrongfully charged VAT is not a VAT payment according to the

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<sup>125</sup> Prop 2005/06:130, p. 61

<sup>126</sup> Prop 2005/06:130, p. 38

<sup>127</sup> <http://www.skatteverket.se/skatter/mervardesskattmoms/sarskilt/omvandskattskyldighetinombyggsektorn/avdragsrattfaktureringochredovisning.4.19b9f599116a9e8ef36800022270.html>

<sup>128</sup> [http://www.bygg.org/Omvand\\_moms.asp](http://www.bygg.org/Omvand_moms.asp)

<sup>129</sup> In Swedish; Sveriges byggindustrier

<sup>130</sup> Deloitte, Ernst & Young, Grant Thornton, KPMG, Skeppsbron Skatt, Svalner, Svenskt Näringsliv

<sup>131</sup> [http://www.bygg.org/Omvand\\_moms.asp](http://www.bygg.org/Omvand_moms.asp) and

[http://www.bygg.org/Omvand\\_moms.asp#F%F6fr%E5gan](http://www.bygg.org/Omvand_moms.asp#F%F6fr%E5gan)

<sup>132</sup> Quigley, Extension of French Reverse Charge Mechanism p. 3

definition in ML chapter 8.<sup>133</sup> The buyer then risks losing the right to get a VAT refund related to costs of purchases. The buyer has to turn to the seller and request the wrongfully paid VAT. At the same time the buyer may be forced to account output VAT on a service he bought himself.<sup>134</sup> The civil law in this field is unclear. It has been argued that the legislator simplifies the right to deduct too much if the present legislation always excludes the right to deduction if VAT is wrongfully charged.<sup>135</sup>

Construction companies that fail to apply the reverse charge mechanism risk incurring penalties consisting of additional fees.<sup>136</sup> A failure to apply the reverse charge mechanism can constitute a risk of criminal liability.<sup>137</sup>

### **6.1.1.2 If the service is construction work**

Since the SNI 2002 has not, since January 2008, been of binding character regarding which services that constitute construction work, problems concerning this have arisen. A starting point on the assessment of whether the services constitute construction work is to be done case by case. It is the objective character of the supply that is decisive.<sup>138</sup>

The Swedish Construction Federation has also, in this respect, made a list in cooperation with consulting firms<sup>139</sup>. The list contains those services, which are to be seen as construction work within the meaning of the reverse charge mechanism. Considerations have been taken from the tax authorities and opinions of the industry. The intention is that the list will continuously be up-dated.<sup>140</sup> The SNI shall be updated in accordance with amendments at EU-level. An ongoing up-date and amendment is expected to result in a new SNI 2007, which will be applicable from 2008. The amendments of SNI 2007 will probably result in an amendment concerning to which construction works the reverse charge mechanism will be applied.<sup>141</sup>

## **6.1.2 Administration**

The application of the reverse charge mechanism means that tax is collected from a larger group of taxpayers. This increases the administration burden for the tax authorities.<sup>142</sup> The introduction of the

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<sup>133</sup> ML 2:1

<sup>134</sup> Quigley, Paul, p. 3

<sup>135</sup> Forssén, Björn, p. 2

<sup>136</sup> Forssén, Björn, p. 2

<sup>137</sup> Quigley, Paul, p. 3

<sup>138</sup> Skatteverkets skrivelse, p. 41

<sup>139</sup> The same as referred to in chapter 6.1.1.1 and in footnote 130

<sup>140</sup> [http://www.bygg.org/Omvand\\_moms.asp#F%F6fr%E5gan](http://www.bygg.org/Omvand_moms.asp#F%F6fr%E5gan)

<sup>141</sup> Renström, Staffan, Mervärdesskatt – omvänd skattskyldighet för byggföretag (VAT – reverse charge in the construction sector), p. 4

<sup>142</sup> European Tax Report 10th of August, p. 1

new system is also costly for the state.<sup>143</sup>

Compared to the general system of VAT, the reverse charge mechanism implies a more complicated and burdensome administration for the companies. This also results in increased administration costs.<sup>144</sup> Each company must use two invoicing systems, instead of one. It is probably more complicated and more burdensome for small and medium-size companies, than for larger.<sup>145</sup>

The companies bear the risk when deciding whether or not to charge VAT. This shifts the responsibility and the financial risk arising from the non-payment of VAT from the tax authorities to the companies, causing potential costs the companies. The risk that transactions are not declared at one particularly point in the chain is not eliminated and therefore all the parties in a chain must continue to be controlled.<sup>146</sup>

### **6.1.2.1 The Need for Review**

In Motion 2007/08<sup>147</sup> members stated that a review of the reverse charge mechanism in the construction sector is needed. Further they state that the purpose of the legislation is good but that the uncertainty concerning definitions have to be cleared up. It has to be clearer which companies shall use the reverse charge mechanism and which companies that shall not. It has to be clearer so that dishonest companies do not benefit from it.<sup>148</sup>

Also the increased administration burden for smaller companies has to be reviewed. The expected burden was to be finite but became more extensive and now has to decrease.<sup>149</sup>

The Committee answered that there are reasons to highlight the definition and administration problems and referred to the government's following up of the development of the reverse charge mechanism. They assure that they are in a state of alert to solve the potential problems that might have arisen. The Committee then opposed the motion.<sup>150</sup>

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<sup>143</sup> Rabe, Gunnar; Momssystemet under attack (The VAT system under attack) p. 2

<sup>144</sup> Prop 2005/06:130, p. 62

<sup>145</sup> Rabe, Gunnar, p. 2. See more in chapter 6.1.5 below.

<sup>146</sup> Rabe, Gunnar, p. 3

<sup>147</sup> Motion 2007/08:SkU20 Allmänna motioner om mervärdesskatt (Parliamentary bill 2007/08:SkU20 General reports on VAT) (Motion 2007/08)

<http://www.riksdagen.se/webbnav/index.aspx?nid=3322&rm=2007/08&bet=SkU20>

<sup>148</sup> Motion 2007/08

<sup>149</sup> Motion 2007/08

<sup>150</sup> Motion 2007/08

### **6.1.3 Increased pressure on the last supplier and new types of fraud**

With the reverse charge mechanism the pressure on the last supplier in the chain increases. The problem with only collecting the VAT in the last line was one of the main purposes of the removal of a tax in Swedish in 1969, which was collected in the same way as in the reverse charge mechanism.<sup>151</sup>

It is expected that new forms and patterns of tax fraud will occur with the reverse charge mechanism. Passing the liability to pay VAT to the tax authorities up the supplier chain will make it more advantageous for the last company to disappear. The reverse charge mechanism is not a solution to the non-payments of VAT, which will continue. For a taxable person, who charges VAT at the top of the chain, the incentive to use workers without paying taxes will increase because he has access to the total amount of the VAT collected in the chain and no longer just the difference of his output VAT and input VAT.<sup>152</sup>

### **6.1.4 Liquidity**

One purpose for the introduction of the reverse charge mechanism was to increase the tax revenue for the state.<sup>153</sup>

#### **6.1.4.1 For the state**

The output VAT is not paid to the tax authorities on a continual basis, which results in the payment being postponed. The tax authorities have to reimburse input VAT, which corresponds to costs for the supply, which results in surplus input VAT being reimbursed before the output VAT is paid to the tax authorities. This confers a negative effect on the state budget, which corresponds to the cost of interest by the liquidity loss.<sup>154</sup>

#### **6.1.4.2 For the supplier**

The effect for the supplier of the services is also negative for the liquidity. In the reverse charge mechanism the supplier never gets access to the VAT from the buyer, which the supplier in the general scheme of VAT can hold and use to pay input VAT for his acquisition of material used for the supplied service, before the output VAT is to be paid to the tax authorities. This is thus the wanted effect of the reverse charge mechanism, that the

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<sup>151</sup> In Swedish “omsättningsskatt”. Rabe, Gunnar, p. 2

<sup>152</sup> Combating VAT fraud in the EU – the way forward, p. 24 Writers comment; this negative effect is applied analogically from the effects of the reverse charge mechanism used to combat carousel VAT fraud.

<sup>153</sup> Prop 2005/06:130, p. 20

<sup>154</sup> Prop 2005/06:130, p. 61

dishonest traders do not have access to the VAT.<sup>155</sup> One can say that the further down the chain a supplier is, the more the liquidity is affected negatively and vice versa.<sup>156</sup>

It has been argued that the liquidity is only marginally affected and that it cannot be said to have an effect on the economic operators since the VAT amount is not to be seen as an amount free to use.<sup>157</sup>

## **6.1.5 Obstacle to free movement of goods and services**

Already before the reverse charge mechanism was introduced, problems concerning the differences between the Member states' different VAT systems were present. After the introduction, it is even harder to follow the VAT systems of the 27 Member states. This concerns especially smaller companies that do not usually have the same opportunity as larger companies to put money into handling these systems.<sup>158</sup>

The question of how this will affect the smaller companies on the internal market has been put forward. According to an investigation made by the Commission, 14 percent of smaller companies avoid cross-border transactions because of the VAT systems. For larger companies only 10 percent avoids cross-border transactions because of the VAT systems. It has been argued that the reverse charge mechanism will increase this number for smaller companies and therefore is an obstacle to the free movement of the internal market.<sup>159</sup>

## **6.2 Positive effects**

### **6.2.1 VAT fraud reduction**

The obvious and wanted effect of the reverse charge mechanism is that dishonest and criminal traders do not get access to the VAT which they 'usually' illegally keep and do not pay to the tax authorities. This also increases the tax revenue for the state.<sup>160</sup>

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<sup>155</sup> Prop 2005/06:130, p. 62

<sup>156</sup> Renström, Staffan, p. 5

<sup>157</sup> Renström, Staffan, p. 5

<sup>158</sup> Rabe, Gunnar, p. 4

<sup>159</sup> Rabe, Gunnar, p. 4

<sup>160</sup> Prop 2005/06:130, p. 12

## **6.2.2 Liquidity**

### **6.2.2.1 For the customer**

For the customer the liquidity effect is positive. The customer can, at the same time as the output VAT is paid, deduct the input VAT. This means that the customer does not have to wait until the right to deduction arises.<sup>161</sup>

### **6.2.2.2 For smaller companies**

A problem in the construction sector is also that larger companies do not pay their invoices in time. This usually causes liquidity problem. The problem for smaller supplier companies is when larger companies do not pay the invoice and the supplier has to pay the output VAT before the payment from the customer is received. The reverse charge mechanism will in this respect give positive effects since the supplier does not need to pay output VAT.<sup>162</sup>

### **6.2.2.3 Insolvency**

The reverse charge mechanism is positive for the companies further down the supplier chain. Often their customers are bankrupt and insolvent. With the reverse charge mechanism the supplier does not have to pay output VAT to the tax authorities without obtaining this amount from their customer, even though they have to wait for their money for the supplied service.<sup>163</sup>

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<sup>161</sup> Prop 2005/06:130, p. 62

<sup>162</sup> Prop 2005/06:130, p. 63 and Forssén, Björn, p. 4

<sup>163</sup> Renström, Staffan, p. 3

# 7 Other techniques to combat tax fraud

Different systems have been introduced in different Member states to stop the tax fraud problem. In the field of VAT, four Member states have introduced the reverse charge mechanism.<sup>164</sup> Furthermore, the Swedish government has stated that the possibility to combat tax fraud on a national level is limited by the VAT directive.<sup>165</sup>

In 2006 the Economic and Financial Affairs Council (the Ecofin) presented strategies to decrease VAT fraud in the EU.<sup>166</sup> Strategies proposed were to step up the coordination between the Member states, to review the Member states' systems of VAT to see if they are effective enough and the possibility to reach a more effective system on information exchange between the Member states. According to the report, the possibilities to introduce a general reverse charge mechanism in the Member states were discussed. It shall be pointed out that the discussion did not reach a decision or a solution.<sup>167</sup>

## 7.1 Increased control

Bodies to which the reverse charge mechanism proposal was referred for consideration suggested that an increased control from the tax authorities was needed. It was also stated that the tax fraud problem is not specific for the construction sector and indicated that the legislation should be more general, rather than specific for the construction sector.<sup>168</sup> The Swedish government responded that it is not sufficient to just increase control and give more information. The construction sector has already had time to try to solve the problem on a voluntary basis. However, no satisfactory

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<sup>164</sup> Prop 2005/06:130, p. 19. Belgium has introduced reverse charge mechanism in 'the property development sector', Austria and Germany have also introduced reverse charge mechanism in the construction sector and the Netherlands made the principal liable for the payment of VAT where sub-contractors are commissioned to supply services, in construction-, metal-, and ship construction sector.

<sup>165</sup> Prop 2005/06:130, p. 30

<sup>166</sup> These strategies were aimed to combat the carousel VAT fraud. This is used analogically here for the purpose of highlighting that there are no, not even at EU level, other methods presented to solve the VAT fraud problem. Rather they are strategies to make existing systems better.

<sup>167</sup> Press Release 2766 th Council Meeting, Economic and Financial Affairs, Brussels, 28 November, 2006 (Ecofin November 2006)

<sup>168</sup> Prop 2005/06:130, p. 30 Writer's comment; this is exactly what the amendment of art 27 in directive 77/338/EEC to art 394 in the VAT directive aimed to avoid. An aim of the derogations in art 194 to 199 in the VAT directive is that the derogations are specific and selective, for the precise purpose of striking the dishonest competitions, see chapter 4.1.1.1.

solutions have been reached. The difficulty to administer control over more than one sub-contractor is too serious.<sup>169</sup>

## 7.2 Deduction system

In a report from the Construction Commission<sup>170</sup> a compulsory deduction system in the sub-contractor chains was suggested. The proposal introduced a system with an obligation to deduct from the reimbursement, paid to the supplier. The deduction system did though not cover VAT.<sup>171</sup>

A similar system was proposed.<sup>172</sup> The proposed system suggested that when a supplier commission a service from a sub-contractor, deduction shall be made from the payment to the sub-contractor. The deducted amount belongs to the sub-contract but shall be paid to the tax authorities. The deducted amount is used as a security for that the sub-contractor pays VAT, fees and other taxes to the tax authorities.<sup>173</sup> The proposed deduction was suggested to be 20 % of the payment to the sub-contractor.<sup>174</sup> The proposal got critic for bringing to much administration burden on the economic operators and to not be enough efficient. The Swedish government never suggested legislation out of the bill.<sup>175</sup>

## 7.3 Reduced rates

The Commission proposed in 2006 reduced rates on labour services for the purpose to avoid distortions of competition, to improve the functioning of the internal market and to prevent payments to workers outside of the system. The proposal was implemented in the VAT directive, which allowed reduced rates on certain services such as renovation of private dwellings, hairdressing, window-cleaning, domestic cares and small repairs.<sup>176</sup>

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<sup>169</sup> Prop. 2005/06:130, p 31

<sup>170</sup> SOU 2001:115, 'Skärpning gubbar' (Improvement needed in the construction sector) (SOU 2001:115)

<sup>171</sup> Prop 2005/06:130, p. 12

<sup>172</sup> Departementspromemorian 2004:43; Byggtreprenadsavdrag samt omvänd skattskyldighet (moms) (Deduction system and reverse charge mechanism) (DS 2004:43)

<sup>173</sup> Prop 2005/06:130, p. 12

<sup>174</sup> Lagförslag i promemorian; Byggtreprenadavdrag samt omvänd skattskyldighet (moms), Ds 2004:43, para. 8

<sup>175</sup> Prop 2005/06:130, p. 13

<sup>176</sup> European Tax Report 10 th of August 2006, p. 3

# 8 Analysis

## 8.1 Introduction

The purpose of this thesis is to examine the reverse charge mechanism, which was introduced in the construction sector in Sweden in 2007. The main question for this thesis to be answered is:

*- Is the reverse charge mechanism an efficient method to combat the VAT fraud in the construction sector in Sweden?*

To be able to answer the above stated question, two other questions will first be discussed;

*- Which effects does the reverse charge mechanism have?*

*- Are the effects proportional to the goal, which it aims to achieve?*

During this thesis, general aims, goals and legislation of the EU have been presented. The stated questions above will be discussed and answered also in the context of these presentations.

The terms of tax evasion, tax avoidance and tax planning will not be discussed in the analysis. Concluding remarks of that discussion were made at the end of the chapter. The aim was to give all readers the same standing concerning the terms, for the understanding of the examination of the reverse charge mechanism.

## 8.2 The effects

In the EU, the tax fraud has over recent years become more sophisticated, which also forces the techniques to combat it to be yet more sophisticated. Proposed solutions to solve the tax fraud must take into account the growing phenomenon. For the moment, the writer doubts that the techniques to fight the tax fraud are sophisticated enough.

The EU shall work for a harmonious, balanced and substantive development of the economic activities within the EU, which includes abolishing obstacles to free movement of goods, persons, services and capital. It also includes having systems ensuring that the competition is not distorted within the internal market and to strength the economic and social coherence.

Both the Member states and the EC shall ensure an effective protection against financial fraud and illegal activities within the EU, which in themselves affect the interests of it. Member states have to fulfil obligations arising from the EC Treaty and where objectives cannot be sufficiently achieved, the EC shall take action. One obligation for the Member states is to counter financial fraud. For the fulfilment of that obligation the EC and the Member states shall coordinate their actions. Harmonisation of legislation on indirect tax is done to the extent necessary to ensure the establishment and the functioning of the internal market.

Tax fraud is a problem that extends beyond the Member states legislation and national boundaries. What shall be noted is that harmonisation of the Member states' legislation can also limit the Member states ability to combat tax fraud. All measures taken by the Member states have to comply with the legislation at EU level.

Furthermore, introduction of derogation VAT schemes into national legislation previously had to be authorized by the Council. Now after the amendment of art 395 (before 27), derogations are approved in advance by the Council for the Member states to introduce. The aim of the amendment was to decrease the number of different derogation schemes and to decrease the administrative work for the Council. Other objectives were to increase transparency and to simplify the procedure of collection of VAT.

The reverse charge mechanism for construction work has its legal basis in art 199(a) of the VAT directive after the amendment of the directive. The Council stated that methods that were proved to be the most efficient in combating tax fraud should be permanently established in the VAT directive. It should also be those methods that were best suited for a common VAT procedure in the internal market. The reverse charge mechanism was introduced in the VAT directive for the purpose of being introduced into Member states in order to solve specific national tax fraud problems. The Member states can therefore choose if they want to introduce the reverse charge mechanism, and if they do – it has to be done in proportion to the national tax fraud problem. It was stated that the reverse charge mechanism was efficient, did not affected customers and introduced minimal additional costs.

The writer observes that the establishment of the reverse charge mechanism in the VAT directive can be seen as making a derogation to a 'general' derogation. On the one hand, this is in opposition to the goal to create a harmonious and approximated market. On the other hand, it can be seen as a system strengthening the protection of financial fraud. Ultimately, it is constantly a balance of interests.

Sweden declared in 2005 that the construction sector was one sector where the tax fraud problem was dominant. This statement was acknowledged with a review of the Swedish law from 1995 to 2003 as base. Sweden applied for authorisation to introduce the reverse charge mechanism under

art 395 (before art 27). This authorisation was never needed since the directive was amended.

The largest problems in Sweden are that the payment of workers in the construction sector is made outside the tax system and that artificial arrangements are made to escape the payment of tax. Tax fraud is usually performed further down the chain of contractors where it is most difficult for the tax authorities to control.

In the preparatory work for the reverse charge mechanism, other techniques were presented as methods to fight the fraud. A deduction system where a deduction of the reimbursement between the supplier and the buyer should be made, where the deducted amount should be paid directly to the tax authorities from the buyer. This was aimed to secure that taxes and fees were paid from the supplier to the tax authorities. This did not concern VAT, but was presented as a technique to decrease tax fraud. Another technique that was proposed was to reduce the tax rates for the purpose of preventing moon-lightening workers. The proposal did cover certain services such as small repairs and renovation. A third proposal was to increase the control by the tax authorities. The Swedish government responded to that it was not sufficient.

The result was that the reverse charge mechanism was introduced to decrease the tax fraud in the construction sector.

I do believe that the reverse charge mechanism is the method worth trying to combat the tax fraud problem in the construction sector. I do also believe that the reverse charge mechanism was introduced too hastily, having prepared neither the economic operators nor the tax authorities for the fundamentally different system. It can be questioned if the hasty introduction of the reverse charge mechanism in fact obstructed its function.

The reverse charge mechanism is derogation to the main scheme of VAT. The purpose of it is to simplifying the collection of the VAT to the tax authorities. The permanent establishment in the VAT directive of the reverse charge mechanism in the construction sector was based on an investigation about the method's efficiency in combating tax fraud.

Both negative and positive effects of the reverse charge mechanism have been presented in this thesis. One can see by the number and space taken, that there are more negative effects than positives effects.

I do wonder if the negative ones could decrease significantly if the tax authorities and the economic operators had been better equipped for the introduction of the reverse charge mechanism. I do also believe that the negative effects already have decreased, since nearly a year has now passed since the reverse charge mechanism came into force in Sweden.

One negative effect that I have stated is the definition problems that arose with the introduction of the reverse charge mechanism. The definition uncertainties concerning the provisions that have to be fulfilled are firstly, whether the customer is a construction company and secondly, whether the service is a construction service within the meaning of the VAT directive (the Swedish ML). The tax authorities have been restrictive in its advice to the economic operators, maybe because of their own uncertainty concerning this issue. This resulted in the Swedish Construction Federation, together with consultant firms, working out lists which shall serve as guidance when the companies decide whether the reverse charge mechanism shall be applied. This list was needed especially since the SNI 2002 was abolished and the services were to be decided according to the general meaning of the word. Thus, the old SNI 2002 did serve as a base during the construction of the new list. One can question what kind of requirements the tax authorities can have on the economic operators when the tax authorities themselves are uncertain.

The legislation concerning the additional fees that can be imposed, and the fact that VAT is not deductible if it is wrongfully charged can be questioned. I do agree that there will be non-coherence in the VAT system if an amount that is not considered as tax according to the legislation is deductible. As the legislation is so uncertain concerning the definitions, additional fees will not be imposed easily. The legislator himself contributes to legal uncertainty, which should not negatively affect the operators on the market. Moreover, the supplier has to identify the status of the buyer. Also here the Swedish Construction Federation has assisted the legislator in constructing a form which can be sent from the supplier to the buyer, where information about the buyer shall be registered so that the supplier sends the right invoice, with or without VAT.

Moreover, the administration costs were supposed to be minimal. Criticisms to this have been acknowledged. The administration has become more difficult than expected, both for the tax authorities and for the economic operators. The fact that two different systems are used parallel to each other when invoicing and controlling tax collection makes it more costly both for the tax authorities and for the economic operators. Especially smaller companies have had increased costs and a more burdensome administration procedure. It has been argued that this can constitute an obstacle to the free movement within the internal market.

Before the reverse charge mechanism was introduced, a number of smaller companies chose to avoid cross-border transactions because the VAT legislation is too complicated to handle. After the introduction of the reverse charge mechanism this number is expected to grow. These criticisms have been reviewed and have been required to be investigated in Motion 2007/08. The response to the motion was that the government is in a state of alert to solve this potential problem. Probably the government wants to wait and assess the effects of the reverse charge mechanism in the

long run rather than just see the difficulties raised with the implementation of it. This may be a wise decision.

The increased pressure on the last supplier has been criticised. I do think that the critic is justified to a certain extent. The reverse charge mechanism does increase the pressure on the last supplier in the contractor chain, because that is where the VAT is to be collected. Thus, it is what the legislator intended since the fraud usually takes place further down the contractor chain. It is usually easier for fraudsters to escape the tax authorities and set up artificial arrangements further down the chain. I believe the increased pressure on the last supplier is a good attempt to decrease the tax fraud, since the investigation in the construction sector showed that a solution was needed to reach the fraud further down the chain. Probably the reverse charge mechanism is the only technique that can stop the fraud further up the chain. The other techniques proposed, are probably good techniques as well, but I do not think they can be used as alternative techniques, rather as additional techniques.

The liquidity effect has been stated both as positive and as negative in this thesis. The liquidity has been said to be negative for the tax authorities since it demands an implementation of a second system. For the supplier it seems negative because the supplier never gets access to the VAT from its customer, which he generally in the main scheme of VAT can use to pay his input VAT for the acquisition of material used for his supply of the services. Furthermore, it has been argued that the liquidity cannot be seen as affected, since the VAT amount shall not be seen as an amount free to be used.

De facto, even though the VAT shall not be seen as an amount free to be used, the economic operators can use it and do so in the main scheme of VAT. A negative liquidity effect will, even if only marginally, be incurred.

To summarize the effect on liquidity, I do believe that concerning the state, the increased costs for introducing a second tax system are paid back by the preventive character of the system; the profit of combating the tax fraud. For the supplier, the negative effect is undeniable but due to the reason that the VAT amount shall not be seen as an amount free to be used, the effect shall not be taken into account to a large extent. Also the fact that the effect is positive for the customer and also in insolvency respects, it cannot be seen as a reason for not introducing or not retaining the reverse charge mechanism, in my point of view.

The question that must be answered is whether it is possible to reduce tax fraud without increasing the administrative burdens on the economic operators that have to comply with the legislation and for the tax authorities that have to introduce a second system. So far, the answer to this seems to be negative. I do think that in the long run, the answer will become positive.

The lack of coherence and coordination from the legislator reduces the effectiveness of the reverse charge mechanism. The burdens imposed on the economic actors should have been better prepared before the introduction of the reverse charge mechanism. It is clear that the situation before the introduction of the reverse charge mechanism was not sustainable.

It can be questioned whether the reverse charge mechanism is the 'least bad' solution of the increasing tax fraud, and whether another long-term solution has to be found. It shall be kept in mind in this discussion that the reverse charge mechanism is derogation to the main scheme of VAT. It is a derogation that has become a more 'general' derogation after the amendment of the VAT directive. If the reverse charge mechanism is working and does prevent the tax fraud, maybe the legislators at EU level should review the whole VAT system. If the main scheme of VAT is not safe enough and 'invites' illegal action, the system should be evaluated for the rationale of the financial cooperation and harmonious market within the EU. The amendment of the VAT directive introduced a derogations system, which is against the general principle of the VAT system.

Finally, as stated above a balance must be struck between the system (the reverse charge mechanism) that tackles tax fraud and the basic VAT principles, particularly the principles of legal certainty, legitimate expectations, the formation of the Common market, fair competition, and proportionality of preventive measures that prevent the free circulation of goods, services, persons and capital.

Facilitating information sharing and providing definitions for the uncertain terms concerning the reverse charge mechanism should be top priority for the Swedish legislator. It can be questioned whether the reverse charge mechanism increased the complexity of the collection of VAT instead of being a simplification thereof. This would clearly be contrary to the aim of the reverse charge mechanism. Fraudsters could exploit weaknesses of the reverse charge mechanism if cooperation and legislation are not sufficiently effective.

It shall also be emphasized that if the reverse charge mechanism successfully decreases the tax fraud in the construction sector, the organized tax fraud will probably move into another sector. Where artificial arrangements are set up for the sole purpose of gaining VAT, these artificial arrangements will probably move to another sector where the reverse charge mechanism is not applied. Then, Sweden (and the EU) needs to think of a solution that will be sustainable in the long run, which is not a derogation to the main scheme of VAT.

## 8.3 Conclusions

The answers to the stated questions are first; yes the reverse charge mechanism is an efficient method to combat the VAT fraud problem in the construction sector in Sweden. Firstly because the tax problem consists of artificial arrangements further down the supplier chain and the reverse charge mechanism puts more pressure on the suppliers further up the chain. Secondly because the suppliers never get access to the VAT and will therefore not appear or disappear for the sole purpose of gaining VAT.

The second stated question was to evaluate the effects of the reverse charge mechanism. The effects are in more detail presented and discussed above. Among others, the reverse charge mechanism affects liquidity and increases administration burden for both the supplier and the customer and also for the tax authorities. It can constitute an obstacle to the free movement principle within the EU, increase the tax revenue to the state, contribute to a market with fair competition and also affect the principle of legal certainty since definitions concerning the application of it are not clear.

The third stated question is whether the effects of the reverse charge mechanism are proportionate to the goal that it aims to achieve. The answer to this is positive. The negative effects of the reverse charge mechanism have in this thesis been more numerous than the positive. Thus, I do believe that many of the negative effects will decrease, or have already decreased, when the reverse charge mechanism has been used for a period.

I do also believe that the reverse charge mechanism is most efficient when it is used to a limited extent, as it aims to, in a specific sector where the tax fraud is dominant. If the reverse charge mechanism is used more as a general system of collecting the VAT, it will probably be exposed to more complicated tax fraud and then almost certainly be deprived its effect. If the Swedish legislators had more foresight and been less naive about the administration burden and the definition problems, then the reverse charge mechanism would had been proportionate from the start, now it will probably take more time before the reverse charge mechanism is as efficient as it can be in combating the tax fraud problem in the construction sector in Sweden.

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