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Carousel fraud

Master thesis
20 points

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Tax Law

Spring

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Summary

Since the abolition of fiscal frontiers in the EU in 1993, intra-Community supplies of goods between taxable persons are exempt from Value Added Tax (henceforth VAT) in the Member State of origin. Instead, the goods are taxed in the Member State of destination at the rate and condition in force in that Member State. This transitional VAT system manages to maintain the diverse fiscal systems in the EU. However, the zero-rating of intra-Community supplies of goods combined with the system of deferred payments for collection of VAT on intra-Community acquisitions of goods exposes the VAT system to carousel fraud.

Carousel fraud consists of contrived circular chains of transactions most commonly involving small, high value goods that are easy to transport such as mobile telephones and computer chips. There are many variations on the series of transactions possible in a carousel fraud. The problem for the tax authorities however fundamentally remains the same: large unpaid VAT liabilities and corresponding VAT repayment claims.

In an attempt to stop the defrauding of their national revenue, Her Majesty's Revenue & Customs (henceforth HMRC) in 2000 introduced its strategy using civil methods in the battle against carousel fraud. Since then HMRC have among other measures, introduced extended verifications, joint and several liability and reverse charge mechanism on intra-UK sales of mobile telephones and computer chips, where the assignment exceeds the value of £5000.

The strategy used by HMRC in their battle against carousel fraud has resulted in a drop in the fraud. However, apart from the burden put on legitimate traders, the losses arising from carousel fraud are still significant. The act of a Member State alone is not enough to fight the fraud efficiently. Carousel fraud is a Community problem and needs therefore to be dealt with at Community level. The search for solutions has taken two approaches; one concerns administrative changes within the framework of the existing VAT system, and the other a change of the structure of the VAT system itself.

The introduction of a flat rate origin VAT system, where intra-Community exports are subject to VAT in the country of origin at a flat rate of 15 %, would effectively reduce the scope for carousel fraud. However, such a structural change requires the unanimous approval of all 27 Member States. In the absence of political consensus on the matter and as the defrauding of the Member States' national revenues continue, there is need for administrative changes within the framework of the existing VAT system. To fight the fraud efficiently, the instruments and the legal framework in the field of administrative cooperation between Member States must be reinforced, improved and complemented. Furthermore, the Member States must coordinate the different measures introduced at national level.

Sammanfattning

Alltsedan avskaffandet av de fiskala gränserna inom EU år 1993 är gemenskapsinterna försäljningar mellan beskattningsbara personer undantagna från moms i ursprungsstaten. Istället beskattas varorna i destinationsstaten enligt där gällande villkor och skattesats. Det nuvarande momssystemet lyckas därmed hantera medlemsstaternas olikartade momslagstiftningar. Det är dock denna nollskattesats kombinerad med systemet med förskjutna betalningar vid uppkrävandet av moms på importerade varor som exponerar det nuvarande momssystemet för karusellhandel.

Karusellhandel består av konstruerade cirkulära kedjetransaktioner och involverar vanligtvis små högkostnadsvaror som är lätta att transportera såsom mobiltelefoner och datachip. Det finns många varianter på karusellhandel men det fundamentala problemet med dem är det samma, nämligen stora belopp av ej betald utgående moms och motsvarande belopp av utbetald ingående moms.

I ett försök att stoppa dräneringen av skatteintäkterna har HMRC år 2000 infört en strategi användandes civilrättsliga metoder i bekämpningen av karusellhandeln. Sedan dess har HMRC bland annat infört så kallade utökade kontroller, solidariskt betalningsansvar och omvänd skattskyldighet vid intern handel med mobiltelefoner och datachip där värdet på varorna överstiger £5000.

Även om ovan nämnda strategi har resulterat i en nedgång i karusellhandeln har den samtidigt inneburit en markant ökad administrativ börda för legitima näringsidkare. Dessutom är de statliga förlusterna som härrör från karusellhandeln fortfarande betydande. Detta tyder på att den enskilda statens agerande är otillräckligt för att effektivt bekämpa karusellhandeln. Karusellhandeln är ett gemenskapsinternt problem och måste därför lösas gemensamt på EU nivå. Sökandet efter möjliga lösningar på karusellhandeln har intagit två riktningar; en av dessa avser administrativa förändringar inom det existerande mervärdesskattesystemet och den andra en förändring av själva strukturen på mervärdesskattesystemet i sig.

Införandet av ett mervärdesskattesystem där gemenskapsintern export beskattas med en enhetlig sats på 15 % skulle effektivt reducera incitamenten till karusellhandel. En sådan strukturell förändring kräver dock enhälligt godkännande från alla 27 medlemsstater. I avsaknad på politisk enighet och då dräneringen av medlemsstaternas skatteintäkter fortgår krävs administrativa åtgärder inom det nuvarande skattesystemet som kan reducera eller eliminera karusellhandeln. För att åstadkomma ett effektivt bekämpande av karusellhandeln måste instrumenten för det administrativa samarbetet mellan medlemsstaterna återupplivas, förbättras och

kompletteras. Vidare måste de administrativa åtgärder som införts i de olika medlemsstaterna koordineras.

Abbreviations

EC	European Commission
ECJ	European Court of Justice
EEC	European Economic Community
EU	European Union
HMRC	Her Majesty's Revenue & Customs
MTIC fraud	Missing Trader Intra-Community fraud
OECD	Organisation for Economic Cooperation and Development
UK	United Kingdom
VAT	Value Added Tax
VIES	VAT Information Exchange System

1 Introduction

1.1 Background

VAT fraud is of major concern for the Member States in the EU and the society as a whole. According to reports, some Member States have estimated the annual losses of national revenue stemming from VAT fraud as up to 10 % of net VAT receipts.¹ Considering that VAT alone, in 2004, represented 17.4 % of the total amount of taxes and compulsory social contributions collected in the EU, gives a clear idea of the extent of the problem and the fraud's effect on the funds that otherwise would be used for public services at national level.²

The type of VAT fraud most frequently reported is carousel fraud. Even though carousel fraud typically involves a limited number of fraudsters, the losses arising from it are substantial. Taking advantage of the flaws in the design of the current VAT system, carousel fraud is a determined and organized large-scale criminal attack on the transitional VAT system, and ultimately our welfare system.³

Apart from eroding the Member States national revenues and hence the EEC budget⁴, carousel fraud distorts competition in the targeted market sectors. Failing in their obligation to pay VAT, fraudsters are able to offer products at lower prices than the ones on the lawful market. This makes it extensively difficult for new traders to enter the market and for already established traders to stay in business.⁵ Effectively, carousel fraud additionally has negative consequences on the economic growth and employment.⁶

¹ The Commission of the European Communities, *Report from the Commission to the council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud*, COM(2004) 260 final, Brussels 16 April 2004, at page 5.

² European Commission, Taxation and Customs Union, *Tackling VAT Fraud: Possible ways forward. Document for the workshops*, at page 1.

³ Romanski, *MTIC Fraud*, Tax Journal, [2007] Issue 877, at page 1.

⁴ The EEC budget includes payments based on a proportion of the VAT collected by the Member States.

⁵ The Commission of the European Communities, *Communication from the Commission to the Council, the European parliament and the European Economic and Social Committee concerning the need to develop a coordinated strategy to improve the fight against fiscal fraud*, COM(2006) 254, Brussels 31 May, at page 3.

⁶ European Commission, Taxation and Customs Union, *Tackling VAT Fraud: Possible ways forward. Document for the workshops*, at page 1.

1.2 Purpose

The fight against carousel fraud is high on the political agenda in the Commission as well as in the Member States. However, as a response to the tax administrations' efforts to detect the fraud, it has become more sophisticated involving even more companies in even more Member States.⁷ With a view to strengthen the fight against the more sophisticated carousel fraud, tax administrations have sharpened their approach introducing a number of measures at national level.

This thesis will study how the typical carousel fraud functions and which elements of the current VAT system that makes carousel fraud possible. Further, the thesis evaluates the measures taken by HMRC, looking critically at their efficiency when reducing the fraud, and their proportionality as regards their effects on legitimate traders. Finally, it is examined whether there is a long-term solution that could be adopted on EU level.

The thesis is directed to readers with merely basic knowledge of VAT and VAT fraud. For reasons of understanding the issues addressed, the initial part of the thesis will therefore describe VAT, its history and its advantages.

1.3 Method and material

This thesis is based on a legal study.

As carousel fraud is a relatively new phenomenon, there is a lack of literature on the subject. Apart from studying Directives, regulations and ECJ case law as well as UK legislation and case law, the information is therefore primarily obtained from EC preparatory works, UK governmental reports and legal articles. It should be noted that the articles are carefully chosen from well-known and reliable periodicals such as *Tax Journal*, *Tax Notes International* and *International Tax Review*, most of which are accessed through Westlaw.

1.4 Delimitations

There are many types of VAT fraud. This thesis will however exclusively deal with carousel fraud. As carousel fraud merely involves goods, VAT on services is outside the scope of the essay and will therefore only be mentioned briefly in the subchapter giving a general description of VAT.

Certainly, it would be interesting to evaluate the varied measures to combat carousel fraud introduced by different Member States. However, due to

⁷ In fact, the goods more and more often pass traders established in third countries. See International VAT Association (IVA), *Combating VAT Fraud in the EU-the way forward*, March 2007, at page 4.

reasons of tax administrations varying transparency as regards their strategy to combat carousel fraud as well as my own language skills making me unable to assimilate information in other languages than Swedish and English, the critical evaluation of measures taken at national level will exclusively concern those of HMRC in UK.

It should be noted that the increased sophistication of carousel fraud, has led to a situation where companies established in third countries, i.e. countries outside the EU, are involved in the fraud.⁸ This is however outside the scope of this essay, which concentrates exclusively on intra-Community trade.

⁸ Also exports to third countries are zero rated for VAT. See Article 146 of Council Directive 2006/112/EEC of 28 November 2006 on the common system of value added tax, henceforth referred to as the Eighth VAT Directive.

2 VAT in the EU

2.1 What is VAT

VAT is a general consumption tax assessed on the value of goods and services. It is a general tax because it applies to all commercial activities (with some exceptions) that involve the production and distribution of goods and the provision of services, and it is a consumption tax because the burden of payment falls on the end-consumer.

VAT is collected in installments on the value added at each stage of the production and distribution process of a commodity or service, culminating with the sale to the end-consumer. Even though VAT applies to sales both to private consumers and to other businesses, only the business purchasers are able to credit the VAT they have paid on their purchases (input VAT) against the VAT due on their sales (output VAT). Recovering any excess credits, the businesses account to the tax authorities for the output tax less the input tax. However in order to be refunded the excess credits, it is a requirement that the purchases are made in course of the business, i.e. to make further supplies or services directly or indirectly sold to end-consumers.

2.2 Intra-Community supplies and acquisitions

There are no frontier controls, checks or formalities when goods are traded between Member States in the EU.

Intra-community supplies of goods are exempted from VAT⁹ with a right to deduct the input VAT on dispatch.¹⁰ In its next VAT return, the purchaser pays the VAT due on the transaction to the country of destination at the rate and condition in force in that country. A requirement however is that supplier as well as purchaser is registered¹¹ for VAT in their Member States respectively.

2.3 The historic development of VAT

Ever since the Member States of the EU adopted the First VAT Directive¹² in 1967, they have been committed, legally as well as politically, to work towards a common system of VAT.¹³

⁹ Article 138.1 of the Eighth VAT Directive.

¹⁰ Ibid, Article 169.b.

¹¹ Ibid, Article 213.1.

¹² Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes.

At the time of the creation of the European Community, the initial six Member States used diverse types of indirect taxation, most of which were cascade¹⁴ taxes. When the decision was taken to finance the EEC Budget with the Community's own recourses, which were to include payments based on a proportion of the Member States collected VAT, the shortcomings of the cascade taxes became obvious.¹⁵ The problem with the cascade taxes was that they made it impossible to determine the real amount of tax included in the final price of a specific product. As a result, there was a constant risk that Member States, in order to subsidise their exports, intentionally or accidentally would overestimate the taxes refundable on exportation. To create an efficient, single market in the EU, the former indirect taxes needed to be abolished and replaced by a transparent turnover tax system that guaranteed tax neutrality and by which the precise amount of tax could be refunded at the point of export.¹⁶

In the early 1970s, all Member States had replaced their diverse turnover taxes with a multi-stage, non-cumulative turnover tax, the VAT. However, as the first two VAT Directives merely laid out the general structures of the VAT system, it was left to the Member States themselves to decide the coverage of VAT and the rate structure. In the financing of the EEC Budget it was important that the Member States had a "common rate of tax on a basis of assessment determined in a uniform manner according to community rules¹⁷". Hence, the main objective with the promulgation and subsequent enactment of the Sixth VAT Directive¹⁸ was to establish a common VAT system with a uniform VAT coverage so that the Member States would levy VAT on the same transactions.¹⁹

The next major step in the move towards a harmonized VAT system took effect on 1 January 1993 when all controls at fiscal frontiers within the EU were abolished.²⁰ In order to fully realize the single market, the European

¹³ Forvass Bo, *EU:s momsstrategi – grunden för ett omfattande reformarbete på momsområdet*, Skattenytt nr 5 2004.

¹⁴ A cascade tax is a tax where no credit is given to traders for tax paid on the purchase of their inputs. Such a tax is therefore a multi-stage cumulative tax. Herein lies the main difference from VAT, which is a non-cumulative tax.

¹⁵ European Parliament Fact Sheets, section 3.4.5. Value Added Tax (VAT), available at http://www.europarl.europa.eu/factsheets/3_4_5_en.htm

¹⁶ European Commission, Taxation and Customs Union, How VAT works, available at http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm

¹⁷ Preamble of Council Directive 77/388/EEC of 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.

¹⁸ Council Directive 77/388/EEC of 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.

¹⁹ European Parliament Fact Sheets, section 3.4.5. Value Added Tax (VAT), available at http://www.europarl.europa.eu/factsheets/3_4_5_en.htm

²⁰ Council Directive 91/680/EEC of 16 December 1991 supplementing the common system of value added tax and amending Council Directive 77/388/EEC by Article 22.8.

Commission proposed to replace the destination based VAT system²¹ that had prevailed until 1993 with an origin based VAT system.²² However, as the VAT rates of the Member States differed widely this proposal was not considered acceptable. Further, there was raised concern of the fact that there was no adequate method of how to reallocate VAT receipts to reflect actual consumption. In waiting for the right conditions to implement the origin based VAT system, the European Community adopted the transitional VAT system.²³

The transitional VAT system is an “origin based” system, under which intra-Community supplies of goods between taxable persons are exempt from VAT in the goods' Member State of origin. Instead the goods are taxed in the Member State of destination at the rate and condition in force in that Member State.²⁴ Without frontier controls, this system manages to maintain the diverse fiscal systems in EU. However, the European Community does not regard this as a long-term solution. The intention is still to eventually move to an origin based VAT system, where the VAT is charged by the supplier of the goods.

With effect from 1 January 2007, the Eighth VAT Directive²⁵ came into force, replacing the Sixth VAT Directive. Apart from bringing all the previous provisions into one piece of legislation, the Eighth VAT Directive secures that all the Member States contribute with the proper amount of VAT to the Community's resources. However, despite the objectives already in the Sixth Directive, there is still no complete uniformity as regards the VAT coverage among the Member States. This is due to the vast number of exceptions and derogations allowed from the standard VAT coverage. Furthermore, as far as the VAT rates are concerned, the Community has merely set out standard VAT rates of between 15% and 25% that each Member State shall apply. As a result, the VAT rates across the Community still differ.

²¹ In a destination based VAT system, VAT is effectively charged at the rate of VAT applicable where the buyer is established.

²² In an origin based VAT system, VAT is charged at the rate of VAT in force where the supplier is established.

²³ European Commission, Taxation and Customs Union, How VAT works, available at http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm

²⁴ Report from the Commission to the Council and the European parliament on the use of administrative cooperation arrangements in the fight against VAT fraud, COM(2004) 260 final, at page 3.

²⁵ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

3 MTIC fraud

VAT fraud takes many different forms. The type most frequently reported is Missing Trader Intra-Community fraud (henceforth MTIC-fraud)²⁶. Causing major concern for the Member States of the EU, MTIC fraud gives rise to significant losses of national revenue across EU and appears to be resistant to traditional VAT enforcement efforts. Even though it is difficult to quantify the exact amount of money involved in MTIC fraud, it is clear that the loss of national revenue is substantial. Apart from the losses of national revenue, MTIC fraud jeopardizes legitimate trade in the targeted economic sectors and distorts competition to the benefit of dishonest traders.

There are numerous variations²⁷ of MTIC fraud. However, the fraud pattern that is the best known is called carousel fraud and consists of contrived circular series of transactions most commonly involving small, high value goods that are easy to transport such as mobile telephones and computer chips.²⁸ Those engaged in carousel fraud exploits two key features stemming from the abolition of fiscal frontiers in 1993, namely that intra-Community supplies of goods are zero rated for VAT and the system of deferred payment for VAT on intra-Community acquisitions of goods.²⁹

3.1 Carousel fraud

There are many variations on the chain of transactions possible in a carousel fraud. Some are more complicated than others. Nevertheless, the problem for the tax authorities fundamentally remains the same: large unpaid VAT liabilities and corresponding VAT repayment claims. The pattern described below is a carousel fraud in its simplest form.

In the first stage trader A, which is registered³⁰ for VAT in Member State X, makes a VAT-free intra-Community supply to trader B in UK, deducting input VAT on dispatch.³¹ Following, B makes a domestic onward supply to C (usually referred to as the broker). This is a standard rate supply and B

²⁶ Simmonite, *Deal or no deal?*, Taxation, [2007] Volume 160, Issue 4123, page 1.

²⁷ Acquisition fraud is another form of MTIC fraud. In the case of a simple acquisition fraud, the goods are imported into a Member State from another Member State, effectively VAT-free. Following the importer makes an onward supply within the Member State of import. This is a standard rate supply and the importer will collect VAT from the customer. Following the importer, without completing a VAT return, fraudulently goes missing failing in the liability to pay the VAT received over to the relevant tax authority.

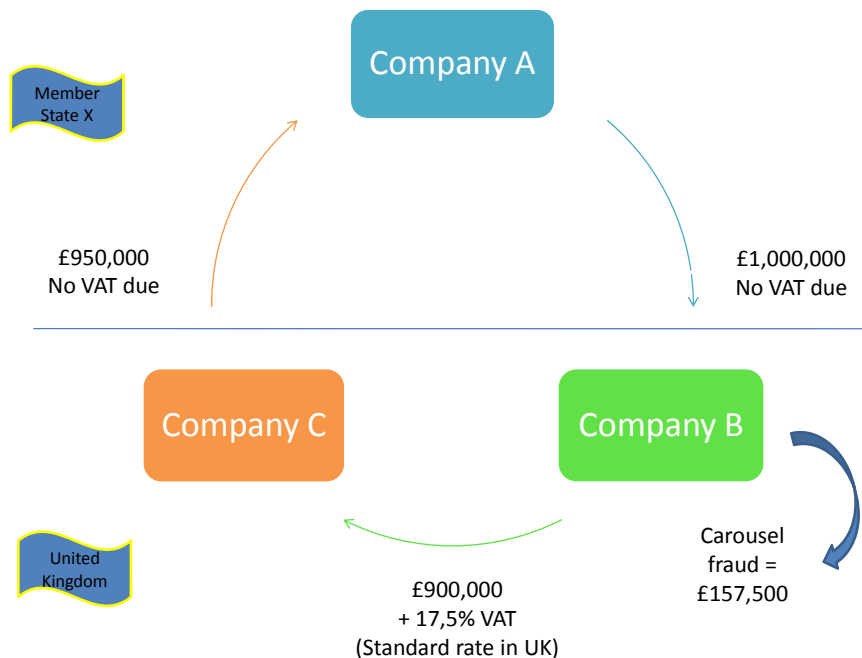
²⁸ Raphael, *The Innocent Trader and the Delinquent Chip*, Tax Journal, [2005] Issue 777, page 23-24, at page 23.

²⁹ The IFS Green Budget 2007, at page 170.

³⁰ Article 213.1 of the Eighth VAT Directive, which stipulates the obligation to register for VAT. It should be noted that the companies may also be using a "hijacked" VAT number.

³¹ Article 138.1 and Article 169.b of the Eighth VAT Directive, stipulating that the supply of goods to an operator in another Member State shall be exempted from VAT, and entitling the supplier to recover input tax on dispatch.

charges and receives VAT on the transaction. At the final stage, C makes a VAT free intra-Community supply, sending the goods back to their original owner, A (who is colluding with the importer), claiming a refund of the input VAT paid to B.³² It is now that the VAT loss crystallises. Under the deferred payment scheme, VAT on B's import is not levied at the border but at the time of its next periodic VAT return. The time lapse between the date of import and the date at which the tax authorities seek payment of the VAT due on the importation is often considerable. In the mean time, B disappears becoming what is referred to as the "missing trader". The result is that B has received, but not accounted for, the VAT that the tax authorities in UK must pay to C.



This contrived circular activity (carousel) may be repeated several times, using the same goods, and if it is successful it creates a situation where VAT refunds are claimed repeatedly every time the goods are exported, while the corresponding import tax liability accumulates, however is never paid.³³

In order to complicate the tax authorities' investigations, a common practice has developed whereby the fraudulent traders distort trading patterns by involving legitimate traders in the fraudulent chain of transactions. Without knowledge of their participation in the fraud, the legitimate traders are

³² Ibid.

³³ The IFS Green Budget 2007, at page 170.

placed between the fraudulent traders in the scheme.³⁴ Otherwise operating in the lawful market, these legitimate traders act without wrongdoing, properly paying their input tax, account for their output tax, and when exporting the goods to another Member State reclaim the VAT they have paid.³⁵ Fraudsters have proven successful in their ability to attract legitimate traders, largely by offering products at prices deviating from the ones on the lawful market.³⁶

3.2 What makes Carousel fraud possible?

VAT, like any other tax, is vulnerable to evasion and fraud. However, the current intermediate transitional VAT system is particularly exposed to fraud, and carousel fraud in particular.³⁷

Carousel fraud owes its existence to predominantly two features of the transitional VAT system, namely the zero-rating of intra-Community supplies of goods combined with the system of deferred payments for collection of VAT on intra-Community acquisitions of goods. The objective behind these features was to create the prerequisites necessary for the establishment of a single market. For instance, with a zero-rating of intra-Community supplies of goods, supplies from other Member States are put on the same foot as domestic supplies.³⁸

However without frontier controls, checks and formalities, goods enter Member States without being taxed. The VAT due on a transaction is not paid at the border, but when the importer makes its' next periodic VAT return. This combination of zero-rated intra-Community supplies and deferred payment breaks the VAT chain at a particularly vulnerable point: the interface of different Member States' tax administrations.³⁹

Up until 1 January 1993, customs agents who were operating at the interstate borders verified liability of VAT and provided an administrative oversight of all cross-border trade, including intra-Community trade.⁴⁰ At the same time as hampering the free flow of commerce, the trade was under

³⁴ Ainsworth, *Carousel Fraud in the EU: A Digital VAT Solution*, Tax Notes International, May 2006, Volume 42, Number 5, at page 444.

³⁵ Gabriel, *Carousel Fraud, Taxation*, [2003] Volume 151, Issue 3907, page 181-182, at page 181.

³⁶ Swinkels, *Carousel Fraud in the European Union*, International VAT Monitor, IBFD, March/April 2008, at page 103.

³⁷ The Commission of the European Communities, *Report from the Commission to the council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud*, COM(2004) 260 final, Brussels 16 April 2004, at page 3.

³⁸ Keen and Smith, *VAT fraud and evasion: What do we know and what can be done?*, IMF working paper No 07/31, February 2007, at page 13.

³⁹ Keen and Smith, *VAT Fraud and Evasion: What do we know, and what can be done?*, IMF Working Paper No 07/31, February 2007, at page 12.

⁴⁰ Ainsworth, *Tackling VAT Fraud: Possible ways forward*, Tax Notes International, March 2007, at page 973.

control and hence resistant to fraud. This system of payment of import VAT was replaced by a functionally equivalent VAT Information Exchange System (henceforth VIES), to which individual traders, registered for VAT in the EU, report their intra-Community supplies and acquisitions.⁴¹ Thus, today the obligation to account for VAT on the acquisition of goods from another Member State lies in the hands of the importer itself.⁴² Due to the deferred payment system, there is often a considerable time lag between the point in time where the goods are imported and the point when the tax authorities seek payment of the VAT due on that particular transaction. In order to practice a control as effective as that of the customs before January 1993, the national tax administrations must collaborate fully with each other.⁴³

Through the use of the measures⁴⁴ instituted to support the new legal and accounting requirements, the tax authorities are, in principle, able to check whether or not the importer adhere to their obligation to account for acquisition VAT on their intra-Community purchases.⁴⁵ In practice however, the exchange of information between the national tax authorities are far from optimal. This leaves fraudsters with plenty of time to generate a substantial amount of money before there is a real risk that the tax authorities discover the fraudulent scheme.⁴⁶

3.3 Why a VAT?

Even though the current VAT system is vulnerable to fraud, there is little doubt among experts that the fundamental principles of the VAT should be preserved.⁴⁷ Since pioneering in France in 1954, VAT has grown hugely popular and to date it is adopted in 136 countries all over the world.⁴⁸ Among the member countries of the OECD, only the United States does not have a VAT system.⁴⁹

⁴¹ Cnossen, *VAT Coordination in the European Union: It's the break in the audit trail, stupid!*, at page 10.

⁴² Article 242 of the Eighth VAT Directive.

⁴³ Swinkels, *Carousel Fraud in the European Union*, International VAT Monitor, IBFD, March/April 2008, at page 104.

⁴⁴ Apart from the heightened administrative cooperation in general, such measures include the VAT Information Exchange System (VIES), and the Intrastat system.

⁴⁵ Ainsworth, *Tackling VAT Fraud: Possible ways forward*, Tax Notes International, March 2007, at page 974.

⁴⁶ Swinkels, *Carousel Fraud in the European Union*, International VAT Monitor, IBFD, March/April 2008, at page 103.

⁴⁷ Commission of the European Communities, *Report from the Commission to the Council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT Fraud*, COM(2004) 260 final, Brussels 16 April, in which the European Commission advise the Member States to search for solutions strictly within the existing VAT arrangement.

⁴⁸ International VAT Association (IVA), *Combating VAT Fraud in the EU-the way forward*, March 2007, at page 45.

⁴⁹ Consumption Tax Trends, OECD, 2004.

There are many reasons for its popularity. Occasionally described as a "money machine"⁵⁰, the VAT system authorizes the revenue services' collection of tax at high rates. Further, VAT has proven to be an exceptionally safe and effective way to raise a broad based consumption tax.⁵¹ In fact, in contrast to other forms of taxation the intrinsic qualities of the VAT makes it relatively unexposed to fraud. Primarily it is its fractional nature, by which the amount of tax at risk at each step of the production and distribution process is limited, which considerably reduces the incentives of making gains from untaxed sales.⁵²

Furthermore, from a Community point of view VAT is considered essential to the achievement of a single market. Allowing intra-Community suppliers refund on input VAT so that goods can leave a Member State free of VAT, while intra-Community acquisitions are taxed on exactly the same footing as domestically produced goods makes the credit mechanism of the VAT crucial for the proper functioning of the internal market. Apart from ensuring neutrality as regards the competitive conditions of the internal market, the modern design of the VAT guarantees free movement of goods and services.⁵³ In addition to its success in treating intra-Community trade, the VAT achieve a high level of simplicity and neutrality as it covers all stages of the production and distribution process, whatever the length of the chain of transactions and no matter whether direct from the producer to the consumer or through wholesalers and retailers.⁵⁴

⁵⁰ Keen and Smith, *VAT Fraud and Evasion: What do we know, and what can be done?*, IMF Working Paper No 07/31, February 2007, at page 3.

⁵¹ International VAT Association (IVA), *Combating VAT Fraud in the EU-the way forward*, March 2007, at page 44-45.

⁵² IFS Green Budget, January 2007, at page 168.

⁵³ Pashev, *Fighting VAT Fraud: The Bulgarian Experience*, Centre for the Study of Democracy, Working Paper 0606/2 En, June 2006, at page 14.

⁵⁴ Preamble of the Eighth VAT Directive.

4 HM Revenue & Customs battle against carousel fraud

In 2000 HMRC introduced its strategy, using civil methods, in the battle against carousel fraud.⁵⁵ Their approach mirrored the measures successfully used by tax authorities in Belgium and the Netherlands. In short, these included: (i) that potential fraudsters would be prevented from registering for VAT; (ii) in the event the fraudsters had already been registered, they would be identified, disrupted in their activities, object to investigation and prosecuted where appropriate. Finally, actions would be taken in order to recover the VAT loss; (iii) discouraging legitimate businesses from trading with fraudsters, hence disrupting their activities; (iv) established traders would get increasing difficulties to reclaim VAT on purchases from suspected suppliers.⁵⁶

Relying on its strategy, HMRC in 2002 took on a particularly aggressive approach when they began denying legitimate traders' their claims for input tax because of their involvement in a transaction chain where one or more of the traders were fraudulent.⁵⁷ The line of reasoning behind this approach was based on HMRC's position that fraudulent activities within a chain transactions, renders every transaction within that chain a non-economic activity⁵⁸, and hence outside the scope of VAT. Regardless of their knowledge of the fraud, legitimate traders that had made intra-Community supplies of goods, which were formerly traded with by fraudsters, were denied their reclaim for input tax.⁵⁹

Primarily for reasons of cash flow, this approach has had major implications for several business sectors. Especially traders dealing with mobile telephones and computer hardware have been particularly badly hit. Some have had to suspend trading and others have even been forced to enter into liquidation.⁶⁰ Such were the situation with the taxpayer in the case *Bond House Systems Ltd v. Customs & Excise Commissioners*⁶¹ where The VAT and Duties Tribunal ruled in favour of HMRC. However, the aggressive approach was challenged when the decision was appealed to the High Court, which referred the case to the European Court of Justice (henceforth ECJ)

⁵⁵ Collins and Gore, *Stopping the Carousel*, Tax Journal, [2007] Issue 889, page 1.

⁵⁶ Report by The Controller and Auditor General: *HM Customs & Excise Tackling VAT Fraud* (2004, HC 357), at page 27.

⁵⁷ Collins and Gore, *Stopping the Carousel*, Tax Journal, [2007] Issue 889, page 1.

⁵⁸ Article 9 (1) para. 2 of the Eighth VAT Directive which stipulates that only what is considered an economic activity is subject to VAT.

⁵⁹ The United Kingdom Parliament, Committee on European Union, Written evidence, Memorandum by Hassan Khan & Co Solicitors 2006/07, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldcom/101/101we06.htm>

⁶⁰ *Ibid.*

⁶¹ [2004] V. & D.R. 125 2003 WL 23841523

which ruled in favour of the taxpayer.⁶² In line with the Advocate Generals earlier published opinion⁶³, the ECJ held that a trader's right to deduct input tax must be assessed individually. The integrity of a particular transaction cannot be altered by earlier or subsequent events as long as the legitimate trader did not know, or had no means of knowing about the fraudulent acts/intentions of the other traders in the chain.⁶⁴ The position was endorsed only months later when ECJ delivered its judgment in *Axel Kittel v. Belgian State*⁶⁵. In this case, ECJ made a clarification stating that tax administrations are allowed to deny input tax from any party "that knew or should have known that, by his purchase, he was participating in a transaction connected with the fraudulent evasion of VAT⁶⁶".

4.1 "The Extended verifications"

Relying on the passages regarding the means of knowledge in *Bond House Systems Ltd v. Customs & Excise Commissioners*⁶⁷ and *Axel Kittel v. Belgian State*⁶⁸, HMRC has since concentrated its efforts on establishing whether the taxpayers reasonably could have known that a fraud was perpetrated somewhere in the chain of transactions.⁶⁹ This so-called "extended verification" of VAT returns has become one of the most significant policies implemented by HMRC and has led to a considerable drop in the fraud.⁷⁰

However, the approach has been widely criticised as it imposes a considerable burden on legitimate businesses. The extended verification is

⁶² Joined cases (C-354/03), (C-355/03) and (C-484/03) *Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs & Excise*, European Court of Justice (Third chamber) 12 January 2006.

⁶³ Opinion of Advocate General Poiares Maduro, delivered on 16 February 2005 in joined cases C-354/03, C-355/03 and C-484/03 *Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs & Excise* and,

Needham, *Advocate General Gives His Opinion In Favour of the Taxpayer in Two Important VAT cases*, VAT Voice, May 2005, available at <http://www.taxationweb.co.uk/articles/article.php?id=173>

⁶⁴ Joined cases C-354/03, C-355/03 and C-484/03 *Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs & Excise*, European Court of Justice (Third chamber) 12 January 2006, at para. 47.

⁶⁵ Joined cases C-439/04 and C-440/04, *Axel Kittel v. Belgian State, Recolta Recycling SPRL v. Belgian State*, European Court of Justice 6 July 2006.

⁶⁶ *Ibid.*

⁶⁷ Joined cases C-354/03, C-355/03 and C-484/03 *Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs & Excise*, European Court of Justice (Third chamber) 12 January 2006

⁶⁸ Joined cases C-439/04 and C-440/04, *Axel Kittel v. Belgian State, Recolta Recycling SPRL v. Belgian State*, European Court of Justice 6 July 2006.

⁶⁹ The United Kingdom Parliament, Committee on European Union, Written evidence, Memorandum by Hassan Khan & Co Solicitors 2006/07, at section 4.6, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldcom/101/101we06.htm>

⁷⁰ The United Kingdom Parliament, Committee on European Union, The Twentieth Report, Chapter 2 para. 28, referring to Rt Hon Dawn Primarolo, quoting the Office of National Statistics: Q231.

an extremely lengthy process by which HMRC refuse to pay input tax refunds until far-reaching enquiries into the underlying transactions are completed. As some transaction chains involve more than 600 companies there are cases reported where VAT repayments have been withheld for more than a year⁷¹, even though the norm for VAT repayments is 30 days.⁷² Additionally, there is no scope to argue special circumstances. No distinction is made for established traders that practice extensive due diligence and otherwise act in accordance with the guidelines.⁷³

As a result of HMRC's actions and approach, traders have become increasingly wary and today many traders instruct legal or accountancy representatives to be present whenever HMRC make site visits or demand documents, leading to increasing legal costs. Further, traders who wait for a decision about the repayment of input tax and want to seek Judicial Review of the reasonableness and procedural propriety of HMRC's action are left with no other option than seeking permission from the High Court. This is a long process resulting in legal costs rising even more, and may even deprive the individual trader of an effective legal remedy. Also, the Court gets clogged and considering the costs involved in the defence in the judicial review, it must be questioned whether this is a justifiable way of using the taxpayers' money.⁷⁴

In addition to this, the House of Lords have expressed their concern about the efficiency of the strategy saying that it may be an unsustainable use of HMRC's resources. At the time of writing 1,500 members of the staff in HMRC are employed executing the strategy at a cost of more than £95 million per year.⁷⁵

Concluding from above, the strategy of "extended verification" does not seem to be proportional to what it is aimed to achieve. Within a reasonable time frame HMRC have the right to make reasonable enquiries into businesses in targeted markets. However, as it is practised the strategy goes beyond that reasonableness. The "extended verification" force legitimate traders to divert a considerable amount of their resources away from their businesses. Apart from the time spent, businesses are affected directly from increased administrative costs and indirectly from cash-flow constraints. The result is that they get difficulties to stay in business. It cannot be proportional to force legitimate traders to go to such lengths considering that their only attempt is to get repayment of input tax. The consequences are

⁷¹ Collins and Gore, *Stopping the Carousel*, Tax Journal, [2007] Issue 889, page 3.

⁷² HM Customs and Excise, *Refunds of VAT in the EC for EC and Non-EC businesses*, Notice 723, June 2003.

⁷³ The United Kingdom Parliament, Committee on European Union, Written evidence, Memorandum by Hassan Khan & Co Solicitors 2006/07, at section 4, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldcom/101/101we06.htm>

⁷⁴ *Ibid.*

⁷⁵ Collins and Gore, *Stopping the Carousel*, Tax Journal, [2007] Issue 889, page 3.

serious and may in the end affect the position of traders in UK and other Member States compared to traders established in other parts of the world.⁷⁶

4.2 The Joint and Several Liability

Pursuant to Article 21 of the Sixth VAT Directive, UK introduced a new section 77A into the VAT Act of 1994.⁷⁷ Through this section, which came into effect on 10 April 2003, HMRC obtained the right to impose joint and several liability on someone other than the person liable for payment of VAT. The provision applies to supplies of telephone and computer equipment and the requirement for this third-party liability is that the person made liable for payment of VAT knew or should have known that, by his purchase, he was involved in a supply chain where VAT was to be unpaid. The objective behind opening up for the possibility to make buffer companies liable for unpaid VAT, was to make legitimate traders more precautionous of with whom they were dealing, which in effect would obstruct the fraudulent activities.⁷⁸

In *Federation of Technological Industries v. Customs & Excise Commissioners* (“FTI”)⁷⁹ ECJ, in 2006, delivered a decision on the provision allowing joint and several liability when a trader, at the time of making a purchase, *knew or had reasonable grounds to suspect* that it formed part of a chain of transactions where VAT would go unpaid. It was stated that such knowledge shall be presumed if the price on a particular supply was lower than the price that may reasonably be expected to be payable for that supply on the market, or if the price was lower than the price on any previous supply of those goods.⁸⁰

Further, ECJ held that legitimate traders taking every precaution that could reasonably be required of them in order to ensure that they do not take part in a transaction where VAT goes unpaid shall be protected from liability.⁸¹ ECJ provided with guidelines of how to formulate a rebuttable presumption directed at determining the knowledge of the trader and made a note saying that the presumptions “may not be formulated in such a way as to make it

⁷⁶ The United Kingdom Parliament, Committee on European Union, Written evidence, Memorandum by Hassan Khan & Co Solicitors 2006/07, at section 4, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/lducom/101/101we06.htm>

⁷⁷ Section 77A of the VAT Act of 1994 was inserted by section 18 of the Finance Act 2003.

⁷⁸ HM Revenue and Customs, Explanatory Memorandum to the Value Added Tax (Amendment of Section 77A of the Value Added Tax Act 1994) Order 2007 No. 939, at page 2.

⁷⁹ *Federation of Technological Industries v. Customs & Excise Commissioners* (C-384/04)

⁸⁰ *Ibid.*

⁸¹ *Ibid.*, and

Charlet, *France strikes back in fraud wars*, International Tax Review, November 2007, available at <http://www.internationaltaxreview.com/includes/magazine/PRINT.asp?SID=697367>

practically impossible or excessively difficult for the taxable person to rebut them with evidence to the contrary⁸²”.

In accordance with the guidelines provided by ECJ in the *FTI* case, HMRC has communicated a list of checks for traders to perform in order to avoid being held joint and severally liable for unpaid VAT in a supply chain. However, it is stated that this list is merely an indicator and therefore neither definitive nor exhaustive.⁸³ Thus, the confusion as to what precautions traders ought to take in order to rebut the presumption is not eliminated. Apart from the legal uncertainty that this causes, the lack of a clear and consistent policy makes the burden of proof as regards their good faith particularly heavy for the trader to bear. In some cases traders have found it practically impossible to rebut the presumption, which is not in line with the statement ECJ provided in the *FTI* case.⁸⁴ Thus to date, a legitimate trader that has taken every precaution can still be caught and made liable for unpaid VAT. In the occurrence of such a case, the legitimate trader is penalized while the real fraudster may go unpunished. Penalizing legitimate traders in the place of real fraudsters simply prevents revenue losses. It does not catch the real fraudsters.⁸⁵

Admittedly, the provision of joint and several liability has contributed to the reduction of revenue losses connected to carousel fraud. However, it does not offer a comprehensive solution to VAT fraud in general.⁸⁶ Even though it eliminates fraud in the trade of telephone and computer equipment, it is highly likely that the fraud diversifies both as to the category of products being traded and the structure of the fraud itself.⁸⁷

⁸² *Federation of Technological Industries v. Customs and Excise Commissioners* (C-384/04)

⁸³ HM Revenue & Customs, *Notice 726 Joint and several liability for unpaid VAT*, March 2008, at section 4.5-4.6 and 6.1, available at http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ShowContent&propertyType=document&id=HMCE_CL_001600#P14_648

⁸⁴ The United Kingdom Parliament, Committee on European Union, Written evidence, Memorandum by Hassan Khan & Co Solicitors 2006/07, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldcom/101/101we06.htm> and, Charlet, *France strikes back in fraud wars*, *International Tax Review*, November 2007, page 5, available at <http://www.internationaltaxreview.com/includes/magazine/PRINT.asp?SID=697367>

⁸⁵ Lasok, *Joint and Several Liability: the Answer to VAT Fraud?*, part 1, [2004] *Indirect Tax Voice*, Volume 66, page 2 and 4, available at <http://theiit.org.uk/ITV66.pdf>

⁸⁶ *Ibid* page 4-5.

⁸⁷ The United Kingdom Parliament, Committee on European Union, Written evidence, Memorandum by Hassan Khan & Co Solicitors 2006/07, at section 11, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldcom/101/101we06.htm>

4.3 The Reverse Charge

Pursuant to Article 395 of the Eighth VAT Directive (formerly Article 27 of the Sixth VAT Directive), UK applied to the Commission for authorisation to introduce a reverse charge mechanism on intra-UK sales of mobile telephones and computer chips, where the assignment exceeded the value of £5000.⁸⁸ In spite of its reluctance to propose exceptions from the principle of fractional payment, the Commission made a proposal to the Council to allow optional use of the reverse charge mechanism in the areas in which it was applied for.⁸⁹

Approved by the Council⁹⁰, the reverse charge mechanism came into force on 1 June 2007.⁹¹ Through these relatively new rules, liability for VAT in business-to-business transactions on above-mentioned supplies is placed on the purchaser rather than the supplier. Thus it is the purchaser (trader C), not the supplier (missing trader B), who accounts and pays the VAT to HMRC. By this new procedure in which the VAT is collected, the opportunities for fraudsters to make gains claiming refunds of VAT that have never actually been paid are eliminated hence avoiding the development of trade carousels.⁹²

Quite so, the carousel fraud has been eliminated in the market areas where it has been most prevalent.⁹³ However, because of the limited application of the rules, the fraud is likely to migrate and mutate into other high value goods, not covered by reverse charging.⁹⁴ After some time, the reverse charge may therefore need to be extended so that it comprises other goods. In that case, the reverse charge system has only created more complexities and administrative problems for legitimate traders of mobile phones and computer chips, and extra work for VAT advisers.⁹⁵ Additionally, the use of reverse charge mechanism limited to certain products has caused boundary issues, leaving traders and VAT advisers with the difficult task of

⁸⁸ HM Revenue & Customs, *BN 46 - Introduction to a Change of the Person Responsible for Accounting for and Paying the VAT on the Sale of Certain Goods*, available at <http://www.hmrc.gov.uk/budget2006/bn46.htm>.

⁸⁹ Commission of the European Communities, *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.

⁹⁰ Article 1 of Council Decision 2007/250/EC of 16 April 2007, authorising the United Kingdom to introduce a special measure derogating from Article 193 of Directive 2006/112/EC on the common system of value added tax. Article 4 provides that the measure is temporary and shall expire on 30 April 2009.

⁹¹ Beusch, *The reverse charge is only a temporary solution*, *De Voil Indirect Tax Intelligence*, [2007], Issue 133, page 17-20, at page 18.

⁹² Collins and Gore, *Stopping the Carousel*, *Tax Journal*, [2007] Issue 889, page 3.

⁹³ Council Directive 2006/69/EC of 24 July 2006.

⁹⁴ Report from the European Union Committee ordered by the House of Lords, *European Union – Twentieth Report*, 8 May 2007, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldcom/101/10107.htm>

⁹⁵ Warren, *Beating the carousel*, *Taxation*, [2007] Volume 159, Issue 4108, page 3 and 6.

determining the border between items subject to reverse charge and items subject to normal VAT.⁹⁶

These problems would be avoided with a general reverse charge as requested by Germany and Austria.⁹⁷ Acknowledging its effectiveness as regards fighting carousel fraud, there is nevertheless little doubt of the shortcomings of an implementation of a general reverse charge. As recognized by the Community, such course of action would undermine one of the key features of the VAT, i.e. the system of fractionated payment.⁹⁸ With a general reverse charge all the VAT due throughout the production and distribution process would be collected at the final sale, transforming the VAT into something similar to a single-stage retail sales tax. From a revenue point of view, such a system would be exposed to even greater losses of national revenue than we see today. If a sale to a final consumer would go unreported in a system of general reverse charge, all of the VAT due would be lost, compared to an unreported sale under the current VAT system where the revenue loss would be limited to the VAT due on that particular unreported sale.⁹⁹

Concluding from above, neither a limited nor a general reverse charge mechanism is the right answer in the fight against carousel fraud in the EU. A reverse charge does not prevent VAT fraud in general, but merely cure carousel fraud.¹⁰⁰ Additionally, a reverse charge is directly contrary to the harmonization of the VAT system as it further diversifies the tax systems of the 27 Member States.¹⁰¹

⁹⁶ IFS Green Budget January 2007, at page 175.

⁹⁷ The request of Germany and Austria concerned the application of a general reverse charge on all business-to-business supplies of goods and services on assignments exceeding the value of EUR5000.

⁹⁸ Communication from the Commission to the Council in accordance with Art. 27(3) of Directive 77/388/EEC, 19 July 2006, COM(2006) 404.

⁹⁹ IFS Green Budget 2007, at page 175.

¹⁰⁰ Warren, *Beating the carousel*, Taxation, [2007] Volume 159, Issue 4108, page 3 and 6.

¹⁰¹ Rabe, *Momssystemet under attack*, Skattenytt nr 1-2 2007, at page 1.

5 Possible solutions

The strategy that HMRC currently use in their battle against carousel fraud has been effective. According to reports, the measures taken by HMRC have resulted in a drop in the fraud.¹⁰² However, apart from the burden put on legitimate traders, the losses of national revenue arising from carousel fraud are still significant. Much more can be done in order to reduce its extent. However, the act of a Member State alone is not enough to fight the fraud efficiently. Arising from the zero-rating of VAT on intra-Community supplies of goods, carousel fraud is a Community problem and needs therefore to be dealt with at Community level.¹⁰³

Broadly, the search for solutions has taken two approaches; one concerns administrative changes within the framework of the existing VAT system, and the other a change of the structure of the VAT system itself.¹⁰⁴ Regardless of which way chosen, any measure introduced to tackle carousel fraud, or any other VAT fraud, must respect the fundamental principles adopted by the European Union. This means that a structural as well as a mere administrative measure must be in accordance with the formation of a common market, fair competition, and the free circulation of goods, services, people and capital. In the same way, any measure must respect the principles enshrined in the First VAT Directive namely; the creation of a single VAT system, neutrality both in terms of the origin of the goods or service and the length of the transaction chain, cover all stages of production and distribution, proportional to the price of the goods, non-cumulative system where input tax is deductible from output tax.¹⁰⁵

5.1 Structural change

Carousel fraud owes its existence to "a fundamental flaw in the design of the VAT system"¹⁰⁶. Thus, removing the transitional VAT system of today, where intra-Community transactions are zero-rated for VAT, would remove the scope of the fraud. There is consensus among experts that the ultimate solution for the single market in the EU would be to introduce an origin VAT system.¹⁰⁷

¹⁰² The United Kingdom Parliament, Committee on European Union, *The Twentieth Report*, Chapter 2 para. 28, referring to Rt Hon Dawn Primarolo, quoting the Office of National Statistics: Q231.

¹⁰³ Plager, *Stop the carousel!*, Taxation, [2007] Volume 159, Issue 4110, page 5.

¹⁰⁴ Keen and Smith, *VAT Fraud and Evasion: What do we know, and what can be done?*, IMF Working Paper No 07/31, February 2007, at page 23.

¹⁰⁵ Preamble of the First VAT Directive.

¹⁰⁶ The United Kingdom Parliament, Report from the European Union Committee ordered by the House of Lords, Twentieth Report: *Stopping the Carousel: Missing Trader Fraud in the EU*, 8 May 2007, in Chapter 1, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldcom/101/10107.htm>

¹⁰⁷ International VAT Association (IVA), *Combating VAT Fraud in the EU-the way forward*, March 2007, at page 15.

In an origin VAT system, intra-Community exports would be subject to VAT in the country of origin at the rate applicable in that country. The importer would be allowed to claim a refund of the VAT paid from the tax authorities in its own country. In this manner, the goods are taxed as if they never crossed the border and hence consistent with the formation of a single market. However, to maintain its character of a tax on consumption rather than a tax on production, the VAT paid to the importer by the country of destination would have to be refunded by the country of origin. This would be accomplished with a clearing house, through which all mutual VAT claims would be settled.¹⁰⁸

As far as the Member States are concerned, the major drawback of the origin VAT system is that it requires a high degree of harmonisation of VAT rates, as traders in Member States with high VAT rates otherwise would have a competitive disadvantage compared to traders in Member States with lower VAT rates. Further, there has been raised concern about the fact that the Member States' national revenue would hinge crucially on whether there is a reliable system as how to redistribute VAT receipts, the level of cooperation between Member States and the integrity of their work. These were also the reasons why the origin VAT system was rejected when proposed to the Member States before the abolition of fiscal frontiers in 1993.¹⁰⁹

For the same reasons as in 1993, there is still resistance to the introduction of an origin VAT system and considering the wide range of VAT rates currently in force, there is no reason to think that political consensus on its adoption will be reached in the near future.¹¹⁰ Instead, a number of other options as how to change the structure of the VAT system have been put forward. Presented below is an option, which is particularly interesting as regards removing the scope of carousel fraud.

5.1.1 Flat rate origin VAT system

In a flat rate origin VAT system, all intra-Community exports are subject to VAT in the country of origin at a flat rate of 15% VAT (the lowest rate of VAT allowed by the Principal Directive). In order to get a refund of the VAT paid, the importer makes a request to the revenue authorities in the country of destination, who subsequently request a refund from the revenue authority in the country of origin. The purchaser would then be required to account for the difference between the 15% VAT paid and the higher or lower rate in the country of destination under the reverse charge. There would be a clearing house to redistribute the revenues collected, but the large transfers between the revenue authorities to account for differences in

¹⁰⁸ Pashev, *Fighting VAT Fraud: The Bulgarian Experience*, Center for the Study of Democracy, Working Paper 0606/2 En, June 2006, at page 11-12.

¹⁰⁹ *Ibid*, at page 11-12.

¹¹⁰ International VAT Association (IVA), *Combating VAT Fraud in the EU-the way forward*, March 2007, at page 17-18.

VAT rates would be avoided. The transfers would only reflect the balance of trade between Member States, hence meeting one of the main objections to the origin VAT system.¹¹¹

There are considerable advantages of a flat rate origin VAT system. To begin with, it would remove much of the scope for carousel fraud. There would still be a risk for the fraud (particularly in countries with high rate VAT), however its profitability would be significantly reduced as it would attach only to the balance accounted for under the reverse charge.¹¹² Furthermore, the introduction of this system would maintain the system of fractionated payment as recommended in the First VAT Directive.¹¹³ In effect, the redistribution of revenue would be reduced, as would the cost and complexity connected with the clearing house, and the risk connected with relying on other Member States to collect and remit tax revenue. Finally yet importantly, a flat rate origin VAT system would take away much of the political pressure to harmonise VAT rates.¹¹⁴

There is however also disadvantages connected with the introduction of a flat rate origin VAT system. Even though they soon would be recouped reducing carousel fraud, the initial costs associated with implementing the system would be substantial on the part of the Member States. Further, there would be an increase in the compliance and administrative costs imposed on businesses. This is especially true for the exporters who would have to make a distinction between domestic supplies taxable at the normal rate, intra-Community supplies taxable at 15 %, and exports to countries outside EU taxable at zero-rate. Moreover, despite its positive effects on carousel fraud, it should not be excluded that the flat rate origin VAT system may lead to other types of fraud, such as fraud related to contrived insolvencies.¹¹⁵

5.2 Administrative measures

Even though the Commission is in favour of taxing intra-Community supplies of goods, such a structural change will not be carried out in many years to come, as that would require the unanimous approval of all 27 Member States¹¹⁶ and to date only very few are in favour of such a change.¹¹⁷ In the absence of political consensus on the matter and as the

¹¹¹ Report from the European Union Committee ordered by the House of Lords, *European Union – Twentieth Report*, 8 May 2007, at section 3.2, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldecom/101/10107.htm>

¹¹² Collins and Gore, *Stopping the Carousel*, Tax Journal, [2007] Issue 889, page 4.

¹¹³ International VAT Association (IVA), *Combating VAT Fraud in the EU - the way forward*, March 2007, at page 27.

¹¹⁴ Report from the European Union Committee ordered by the House of Lords, *European Union – Twentieth Report*, 8 May 2007, at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldecom/101/10107.htm>

¹¹⁵ International VAT Association (IVA), *Combating VAT Fraud in the EU-the way forward*, March 2007, at page 27-28.

¹¹⁶ Article 93 in the consolidated version of the Treaty Establishing the European Community.

¹¹⁷ Collins and Gore, *Stopping the Carousel*, Tax Journal, [2007] Issue 889, page 4.

defrauding of the Member States' national revenues continue, there is therefore need for administrative changes within the framework of the existing VAT system.¹¹⁸

5.2.1 Administrative cooperation - what has been done to date?

The first legal instrument in relation to administrative cooperation in tax matters in the EU was Council Directive 77/799/EEC of 19 December 1977.¹¹⁹ Targeted at coping with the anticipated tax evasion and tax fraud, the Directive engaged Member States to exchange three categories of information; exchange on request concerning a particular case¹²⁰, automatic exchange¹²¹ and spontaneous exchange¹²². The exchange of information could only be conducted between competent authorities¹²³, requiring each Member State to set up a single central liaison office through which all contacts for the purpose of administrative cooperation would go.¹²⁴

The abolition of fiscal frontiers in 1993 necessitated a strengthened cooperation between the Member States. Therefore, Regulation (EEC) No 218/92¹²⁵ was adopted to supplement the Directive of 1977. The principal innovation of this regulation was the provision for a computerised system, the VIES, wherein every competent authority was to maintain an up to date electronic database containing VAT information relating to intra-Community transactions. Every taxpayer making an intra-Community supply and/or acquisition was now obliged to report this to the electronic database and the information achieved had to be communicated automatically to the competent authorities of the other Member States whenever there was a risk of tax loss due to a breach of VAT legislation.¹²⁶ Even when there were no such risk at hand, there would also be information to which the competent authorities had to grant direct access, namely information about VAT registered taxpayers and the total value of their

¹¹⁸ Awaiting political consensus for a structural change, the Commission has decided to concentrate its efforts on fighting VAT fraud on an administrative level. See their short term action plan in *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on a coordinated strategy to improve the fight against VAT fraud in the European Union*, COM(2008) 807 final, Brussels 1 December 2008.

¹¹⁹ Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation and value added tax as amended through Council Directive 79/1070/EEC of 6 December 1979.

¹²⁰ Ibid, Article 2.

¹²¹ Ibid, Article 3.

¹²² Ibid, Article 4.

¹²³ Ibid, Article 1 (a) para.1.

¹²⁴ Grandcolas, *Managing VAT in a Borderless World of Global Trade: VAT Trends in the European Union - Lessons for the Asia-Pacific Countries*, Bulletin for International Taxation, April 2008, at page 137.

¹²⁵ Council Regulation (EEC) No 218/92 of 27 January 1992 on administrative cooperation in the field of indirect taxation (VAT), NB! No longer in force.

¹²⁶ Article 4 para. 1 of Council Regulation (EEC) No 218/92

intra-Community supplies of goods.¹²⁷ If the information received proved insufficient to determine and collect the proper amount of VAT, the competent authority was allowed to make further requests. Such a request had to be responded to as quickly as possible, and no later than three months following the date of the request.¹²⁸

Consolidating earlier provisions¹²⁹, Council Regulation (EC) No 1798/2003¹³⁰ came into force on 1 January 2004 and is to date the single legal instrument governing the administrative cooperation in relation to the proper assessment of VAT in the EU. Since entering into force, this regulation has been subject to mere minor amendments.

In order to complement the legislative initiatives described above, the Council and the European Parliament adopted the Fiscalis 2003-2007 programme. With the intention to further intensify the day-to-day cooperation, this programme has provided funds giving tax officials the opportunity to participate in seminars, exchanges, study visits and project groups where they work together in specific areas.¹³¹ Participation has also been open to candidate countries, giving them the chance to improve the functioning and efficiency of their tax administrations, and thereby enabling them to adapt quicker to the level of cooperation when acceding into the EU.¹³²

Due to the overall satisfaction¹³³ with the Fiscalis 2003-2007 programme, the Council has adopted a successor to the programme, namely Fiscalis 2013, which will run to the end of 2013.¹³⁴

¹²⁷ Article 4 para. 2 and 3 of Council Regulation (EEC) No 218/92

¹²⁸ Article 5 para. 1 of Council Regulation (EEC) No 218/92

¹²⁹ Council Directive 77/799/EEC of 19 December 1977 and Council Regulation (EEC) No 218/92 of 27 January 1992.

¹³⁰ Council Regulation (EC) No 1798/2003 of 7 October 2003 on administrative cooperation in the field of value added tax.

¹³¹ Commission of the European Communities, *Report from the Commission to the Council and the European Parliament on the use of administrative cooperation in the fight against VAT fraud*, COM(2004) 260 final, Brussels 16 April 2004, at page 8.

¹³² Commission Staff working document, Annex to the Proposal for a decision of the European Parliament and of the Council establishing a Community programme to improve the operation of taxation systems in the internal market (Fiscalis 2013), SEC(2006) 566, Brussels 17 May 2006, available at

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52006SC0566:EN:NOT>

¹³³ Commission Staff working paper, the mid-term evaluation, SEC (2005)1045 of 29 July 2005, showed that the participating countries experienced that the Fiscalis 2003-2007 among other things led to an improved cooperation as well as an enhanced mutual-confidence in each other's tax administrations.

¹³⁴ Decision No 1482/2007/EC of the European Parliament and of the Council of 11 December 2007 establishing a Community programme to improve the operation of taxation systems in the internal market (Fiscalis 2013) and repealing Decision No 2235/2002/EC.

5.2.2 Reinforcing, improving and complementing the administrative cooperation

To date, considerable efforts have been put into achieving a decentralization and improvement of the administrative cooperation between tax authorities.¹³⁵ Still, there is dissatisfaction among the competent authorities, which complain about the lack of an efficient cooperation leaving them defenceless to the defrauding of their national revenue.

According to the Commission, the instruments in the field of administrative cooperation on VAT need to be complemented and improved. At the same time however, the Commission recognizes that the instruments already in place offer genuine opportunities for cooperation and that the Member States make insufficient use of them.¹³⁶ In addition to improving and complementing the instruments, the use of the available instruments must therefore be reinforced.¹³⁷

When focusing on reinforcing the available instruments, it is important to recognize the reasons why they are not fully utilized in the first place. One of the reasons for this is a problem of language. Even though all cooperation is conducted in English, most tax officials do not speak English as their mother tongue. Consequently, many of them lack the English skills required for an efficient cooperation. This has sometimes led to misunderstandings in the communication, causing a lot of frustration.¹³⁸ At times, such non-productive experiences have put the requesting tax administration off from making approaches to that particular tax administration in other cases. Another explanation for the reluctance to use the instruments available has to do with incentives. A staff assigned to assist all other tax authorities than the one that remunerates them hardly adds to their incentives. Additionally, the staff may indirectly benefit from not sharing information about a domestic company. By protecting the company, the funds that otherwise

¹³⁵ Apart from the directives and regulations already in place, there are a large number of written communications issued by the commission addressing the problems of the administrative cooperation and recommending measures for improvement.

¹³⁶ Commission of the European Communities, *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee concerning the need to develop a coordinated strategy to improve the fight against fiscal fraud*, COM(2006) 254 Final, Brussels 31 May 2006.

¹³⁷ Commission of the European Communities, *Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee on a coordinated strategy to improve the fight against VAT fraud in the European Union*, COM(2008) 807 final, Brussels 1 December 2008, and,

Press Release from the European Commission, IP/06/697, *EU coherent strategy against fiscal fraud - Frequently asked questions*, Brussels 31 May 2006.

¹³⁸ International VAT Association (IVA), *Combating VAT Fraud in the EU - the way forward*, March 2007, at page 41.

would be tax paid in another Member State can thereby remain in the Member State and be applied in the local economy.¹³⁹

Both of the problems cited above can be resolved by giving the tax administrations the right financial incentives. That can be done by introducing a system where every tax administration, that assists another Member State's tax administration in its work to uncover VAT fraud, gets share in a bonus, which is made up from the all of the VAT collected as a result from cooperation between the Member States. Later on the individual employee would be rewarded through an increased salary, a bonus or similar.¹⁴⁰ Quite effectively, such a system would reduce the language barriers and at the same time ensure a high quality work performance on the part of the employees at tax administrations when cooperating with other Member States.

Even though the introduction of a system of financial incentives would reinforce tax administrations' use of the existing instruments, obstacles for an efficient and smooth cooperation capable of reducing carousel fraud would still remain. One of the obstacles that tax administrations have experienced is the much too time-consuming process when exchanging information with each other. As a result, they often get information about an intra-Community supply or acquisition when it is too late.¹⁴¹

To overcome lengthy exchanges of information, the Commission recently proposed an improvement of the current legislation by amending the Regulation of 2003¹⁴² as regards the timeframe within which a competent authority must grant access to certain information. Proposed to enter into force on 1 January 2010, the amendments will, if adopted, introduce a new time limit of one month, instead of the three months earlier in force.¹⁴³ It should however be noted that this proposal is part of the Commissions short term action plan¹⁴⁴ and that even a one month time limit may be insufficient to effectively combat carousel fraud.

In the battle against carousel fraud, it is crucial that tax administrations have rapid, if not immediate, access to detailed information about intra-Community trade. Acknowledging that none of the instruments currently in

¹³⁹ International VAT Association (IVA), *Combating VAT Fraud in the EU - the way forward*, March 2007, at page 41.

¹⁴⁰ *Ibid.*

¹⁴¹ Grandcolas, *Managing VAT in a Borderless World of Global Trade: VAT Trends in the European Union - Lessons for the Asia-Pacific Countries*, Bulletin for International Taxation, April 2008, at page 137.

¹⁴² Council Regulation (EC) No 1798/2003 of 7 October 2003 on administrative cooperation in the field of value added tax.

¹⁴³ Proposal for a Council Regulation amending Regulation (EC) No 1798/2003 to combat tax evasion connected with intra-Community transactions, COM (2008) 147 final, Brussels 17 March 2008.

¹⁴⁴ Commission of the European Communities, *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on a coordinated strategy to improve the fight against VAT fraud in the European Union*, COM(2008) 807 final, Brussels 1 December 2008.

use (VIES included) have kept pace with recent technological developments, it is clear that they do not have this capacity. To keep up with intra-Community trade, it is therefore necessary to improve and complement these instruments with more modern and efficient tools.¹⁴⁵

The introduction of a system which monitors transactions in real-time would effectively realize a rapid exchange of detailed information. In such a system, all tax authorities would be granted open access to all traders' accounts displaying every transaction as it occurs. The initial costs of implementing the system would be high, both for tax administrations and for traders.¹⁴⁶ As regards the tax administrations, the benefit of the system, in terms of eliminating carousel fraud, would most certainly outweigh the initial costs.¹⁴⁷ This may even be true for the traders since such a system would speed up the process in which the tax administrations validate and verify their transactions. In this way, legitimate traders would get a refund of VAT reclaims without delay.¹⁴⁸

5.2.3 Administrative coordination

In addition to the administrative instruments achieved at community level, the Member States have (as exemplified under section 4.1) introduced a number of measures on national level. Some of them have been successful in disrupting carousel fraud and others have not.¹⁴⁹ In any event, to fight carousel fraud effectively the administrative response needs to be coordinated between the Member States. Moreover, one shall not underestimate the effect that the differences in administrative procedures have on intra-Community trade. According to reports, some traders even refrain from intra-Community trade to avoid the complex administrative procedures that comes along with it.¹⁵⁰

Registration for VAT is the prerequisite to committing carousel fraud. It is therefore imperative that tax administrations can trust that the VAT status of a trader reported to VIES is correct. Today that is however not always the case. There are for instance examples of Member States that keep VAT identification numbers valid even though the taxable person has gone

¹⁴⁵ Press release from the European Commission, IP/07/1754, *VAT: The European Commission suggests ways to improve administrative cooperation in the fight against VAT fraud*, Brussels 23 November 2007.

¹⁴⁶ International VAT Association (IVA), *Combating VAT Fraud in the EU - the way forward*, March 2007, at page 38.

¹⁴⁷ Report from the European Union Committee ordered by the House of Lords, *European Union – Twentieth Report*, 8 May 2007, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldecom/101/10107.htm>

¹⁴⁸ International VAT Association (IVA), *Combating VAT Fraud in the EU - the way forward*, March 2007, at page 38.

¹⁴⁹ Commission of the European Communities, *Report from the Commission to the Council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud*, COM(2004) 260 Final, Brussels 16 April 2004, at page 14.

¹⁵⁰ Grandcolas, *Managing VAT in a Borderless World of Global Trade: VAT Trends in the European Union - Lessons for the Asia-Pacific Countries*, Bulletin for International Taxation, April 2008, at page 131.

missing committing carousel fraud.¹⁵¹ Thus, the key focus of attention should be to establish a coordinated approach to the registration and deregistration process of taxable persons in the EU. A sensible approach would evidently include the introduction of minimum standards for registration and deregistration of taxable persons. Further, a common standard of how to make thorough checks on people trying to register, for example by making background checks and on-site visits would be desirable. Additionally, if the officials sense a dubious registrant, that registrant would be obliged to provide a security.¹⁵²

Moreover, there is need to fully integrate a common approach into the tax administrations' way of managing the VAT system. In order to enhance the protection of the national revenues of all Member States, tax authorities must not only protect their own national VAT receipts but also take responsibility for the VAT receipts of other Member States. However, this cannot be achieved without sufficient political commitment from the Member States, and there may be need to introduce fines for those Member States that are negligent in the protection of other Member States' VAT receipts. As regards the common registration and de-registration process, a Member State that has failed to update the database of its registered traders, could for instance be made liable for any VAT loss incurred by another Member State because of this failure.¹⁵³

¹⁵¹ Commission of the European Communities, *Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee on a coordinated strategy to improve the fight against VAT fraud in the European Union*, COM(2008) 807 final, Brussels 1 December 2008, at page 5.

¹⁵² Keen and Smith, *VAT Fraud and Evasion: What do we know, and what can be done?*, IMF Working Paper No 07/31, February 2007, at page 24.

¹⁵³ Press release from the European Commission, IP/07/1754, *VAT: The European Commission suggests ways to improve administrative cooperation in the fight against VAT fraud*, Brussels 23 November 2007.

6 Final Remarks

Admittedly, the strategy of HMRC has been effective resulting in a drop in carousel fraud. It can however be questioned whether their measures actually are efficient and additionally whether they are proportional considering their effects on legitimate traders.

Certainly, it is a difficult task for tax administrations to strike a balance between their own interest to protect the national revenue from losses and the interest of businesses wanting to avoid any administrative burden imposed on them in the course of their business. A compromise is necessary and should be based on a mutual understanding of the wider interests for businesses as well as the society as a whole. Hence, tax administrations have to realize that they may have to live with a certain extent of carousel fraud and equally businesses have to realize that a certain degree of administrative burden to fight the fraud is necessary and that it actually is to their own benefit as the fraud distorts the competition.

Concluding from paragraph 4 above, none of the evaluated measures of HMRC seems to strike this balance. Even though they have contributed to a reduction in carousel fraud, they have significant and undesirable side effects for businesses having to comply with severe administrative demands. To make legitimate traders, that are acting in a responsible manner, face compliance costs (in terms of both time and money) reaching levels that ultimately threatens their existence is highly dubious. Making them liable for loss of national revenue even though they have taken every precaution to ensure that they do not take part in fraudulent transactions is equally dubious. It is in this context important to recognize the traders' role as unpaid VAT collectors. In fulfilling their obligation to collect state funds on behalf of the Member States, the traders deserve certain rights, in particular legal certainty. For instance, it cannot be too much for traders to ask for a definitive and exhaustive list of checks to perform in order to avoid being held joint and severally liable for unpaid VAT. All things considered, the administrative burden imposed on businesses goes beyond what is reasonable and hence can hardly be considered proportional.

Neither do the evaluated measures appear to be efficient. Through history, fraudsters have always shown an ability to find new ways of defrauding once a new measure is introduced to reduce or eliminate their activity. In order to combat carousel fraud efficiently, it is therefore crucial that the measures are refined and targeted at the fraudulent parties. Neither the provision of joint and several liability nor the limited application of a reverse charge has these crucial qualities. Instead of offering a comprehensive solution to carousel fraud, they entail the evident risk that the fraud diversifies as to both the category of products being traded and the structure of the fraud itself. Thus, the costs of implementing the measures and the costs for compliance imposed on traders will most likely be in vain.

Further, the extended verifications have proven extensively expensive for HMRC causing House of Lords expressing their concern of whether the execution of the measure is sustainable use of taxpayers' money. Apart from the cost of executing extended verifications, the measure imposes a huge burden on legitimate traders, which in effect lose their incentives to stay or get involved in the targeted business areas. This does not only cause loss of potential national revenue, but does also have negative effects on economic growth and employment.

The above mentioned measures of UK have been introduced ad hoc, without sufficient coordination with other Member States, and does not offer a comprehensible and sustainable solution to carousel fraud. The act of UK or any other Member State alone will not be enough to fight the fraud effectively. Stemming from the zero-rating of VAT on intra-Community exports, carousel fraud is a Community problem and therefore needs to be dealt with at Community level. A joined up action is long over-due.

One of the main motives behind the creation of the EU was to create a single market, among other things characterised by the free movement of goods. A common system of VAT is an important part of the realisation of a single market and for a long time the origin VAT system has been envisaged as the ideal alternative in achieving this aim. Such a structural change would also remedy the break in the VAT-collection chain and hence provide a long-term solution in the elimination of carousel fraud. It should further be noted that the concern that was raised in 1993 (when the Member States rejected the origin VAT system) regarding the costs involved in the implementation of a reliable system for redistribution of VAT receipts probably has lost its validity. The technological evolution since 1993 is of major significance and the possibilities of providing such a system at a reasonable cost is today more realistic than before. However, as the resistance to the harmonising of the VAT rates still remains, the introduction of an origin VAT system will not take place any time soon. The flat rate origin VAT system, which relieves the political pressure to harmonise VAT rates and additionally significantly reduces the scope for carousel fraud, is therefore perhaps more likely to be introduced when/if the 27 Member States reach unanimous approval of a structural change of the VAT system sometime in the future.

In the absence of political consensus on a structural change of the VAT system, and as the defrauding of the Member States' national revenue continue, there is need for administrative changes within the framework of the existing VAT system and that can be implemented closer in time. Clearly, there is no "one" single measure capable of eliminating VAT fraud altogether but some pragmatic actions that taken together could be effective and efficient.

Ever since the abolishing of fiscal frontiers in 1993, a Member State's collection of VAT depends on the administrative efficiency of the tax authority in the trading partner's Member State. Thus, a good administrative

cooperation between the tax administrations of the Member States is crucial in the fight against carousel fraud. The instruments in the field of administrative cooperation of VAT must therefore be reinforced, improved and complemented, taking advantage of recent technological developments. Especially the introduction of a system which monitors transactions in real-time would provide the tax authorities with a much improved position in preventing carousel fraud. That would also be achieved with an extended coordination of the different administrative measures introduced at national level in the Member States.

It should however be emphasized that any change other than a structural change of the VAT system itself would merely be a short-term solution in the fight against carousel fraud.

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