Value Added Tax (VAT) Carousel Fraud in the European Union

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Abstract. Objectives: The central aim of this paper is to determine as accurately as possible the nature, extent and cost of vat carousel fraud to the public and private sectors within the European community. Prior Work: The European Union (EU) Institutions and Member states have put forward several measures to tackle this problem, although some of these have placed a disproportionate burden on business. A lot of countries have imposed distinct measures to combat VAT carousel fraud and important lessons have been emerged about their efficiency and compliance. Approach: The methodology takes a comprehensive review of prior research evaluating real evidence of VAT carousel fraud and analysing attempts by the European Union to tackle effectively VAT carousel fraud. Results: The study concludes that the possible solutions are in the field of closer cooperation and understanding among related parties as well as the application of combined restrictive measures. Implications: The study has implications to the society, managers and policy makers. The results will aid national authorities to implement and share best practice to combat VAT carousel fraud with other national governments. Value: Confronted with the drastic increase of VAT carousel fraud, the European Commission identified the urgent need of a coherent strategy to combat it. Yet, neither the literature nor the practices of tax and law enforcement have addressed the threat adequately. This study research gives approaching solutions to delineate essential procedures and principles to embark upon VAT carousel fraud.

Keywords: VAT fraud; MITC fraud; VAT carousel fraud; European Union

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1 Introduction

European VAT fraud is growing at an alarming rate- both in its quantum and its level of sophistication – to the point that it is today beginning to affect the accuracy of Member states' trade statistics. Estimates vary concerning the actual level of VAT losses, with figures ranging from €20 billion to €35 billion per annum for all member states (Borselli, 2011). Whatever the actual level of fraud, these figures highlight the urgent need for Europe to address the issue of the reform of the VAT system.

The suppression of fiscal borders in the EU has allowed businesses to purchase goods and services cross-border without being charged VAT. This is the source of much of the missing trader intra-community (MITC) fraud, or carousel fraud,

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predominantly achieved using mobile telephones and computer chips as a conduit to facilitate the fraud.

Member states have introduced their solutions in order to tackle VAT carousel fraud. Whilst the distinct measures focus on addressing VAT fraud, it is regrettable that to date the solutions put forward by Member states, appear to have been drawn up without significant levels of coordination. This lack of coherence and coordination reduces the effectiveness of the measures, places an extreme burden on legitimate businesses and acts to the detriment of Europe's competitiveness as a whole (International VAT Association report, 2007).

The goal of this work is to attempt to value and assess the actual level of VAT carousel fraud within the EU by reviewing all the academic literature and a variety of reports. The central aim of this study is to determine as accurately as possible the nature, extent and cost of fraud to the public and private sectors.

As a conclusion, a drastic change in the VAT system might provide a robust defense, where enhancing risk management and exchange of good practices is essential. Furthermore, recommendations of appropriate strategies to facilitate the comprehensive and consistent recording of data on fraud, is given in the final section of this article.

2 Missing Trader Intra-Community Fraud and Carousel Fraud

Missing trader intra-community (MITC) fraud, of which carousel fraud is the best example, exploits the refund of VAT to exporters to milk the VAT system of revenues through a series of contrived transactions (Keen and Smith, 2006). Studies by Ligthart (2006) and Needham (2006) explained that MITC or carousel fraud occurs when a registered trader imports commodities from a supplier in another EU member country, invoices and collects VAT at home but fails to remit the tax to the home authorities. By the time the tax authorities have detected the fraud the company has already disappeared.

The two key features of the VAT that are exploited in the carousel fraud are the VAT zero-rating of exports and the system of deferred payment for VAT on imports, adopted in the EU since the removal of fiscal frontiers in 1992 (HM Customs and Excise Report, 2002; OECD Economic Survey: United Kingdom Report, 2007). Under deferred payment, VAT on imports from one member state into another is levied not at the border but at the time of the importer's next periodic VAT return. As a result, there may be a considerable time lag between the date at which the importing company (Company B) imports the goods and the time at which the VAT authorities seek payment of the VAT due. In the mean time, the goods are sold, via complicit-or perhaps unwitting-'buffer' companies in the UK, to company D, which exports the goods, claiming a refund of the VAT that it paid when purchased the goods from company C.

Although VAT carousel fraud is often committed involving intra-Community transactions, carousel fraud does not necessarily depend on the presence of a cross-border transaction in the chain of supplies. Carousel fraud may also be committed by the supplier in domestic transactions if he collects VAT on sales from the purchaser and simply does not remit the VAT to the tax authorities. In addition to fully domestic carousel fraud, the EU has seen a rise in cross-border carousel frauds where the cross-border supply comes from a non EU country (Tumpel, 2007).

As the above research prevail, the scale of the fraud is outsized and it is well known that the European Parliament, the European Economic and Social Committee as well as the European Commission indicated a need to develop a coordinated strategy to improve the fight against fiscal fraud. As a conclusion, the most pressing need seems to be for a VAT strategy that will effectively deal with MTIC or carousel fraud (Ainsworth, 2008).

3 Evidence of VAT Carousel Fraud

3.1 The UK

Ruffles et al (2003) gave light on the impact of VAT carousel fraud on the Balance of Payment Statistics and UK National Accounts. They have explained that this type of fraud impacts on intra-EU trade statistics as they are collected via the VAT system. Whilst carousel transactions are captured in export data, the acquisition of the goods in MITC frauds is not included in import data. Imports are, therefore, under-recorded. They have concluded that this fraud is also a factor contributing to the recent widening asymmetry between the UK and other EU Member States' trade data.

Considerable attention has to be specified when UK economists were surprised by an unexpected trade gap in figures released by the Office for National Statistics in July 2005. The gap had widened by almost £1 billion in a single month, leading some to believe that carousel fraud had distorted the figures. Additionally, statistics issued by HM Revenue and Customs one year later, indicated that VAT fraud had reached record levels, where criminal activity accounted for £7.4 billion in the last quarter alone (National Audit Office Report, 2006).

UK government has published annual estimates of VAT losses/gap, based on a comparison between actual VAT receipts and an estimate, largely from National Accounts data on household spending, of the hypothetical VAT revenue that would be obtained with full compliance: the 'theoretical total VAT liability'. In the year 2005-06, the VAT losses amounted to £12.4 billion or a percentage of 14,5 VAT gap. The estimates for this latter year show a marked reversal of the downward trend and a sharp jump of nearly £3 billion in the amount of revenue lost compared with the previous year (The IFS Green Budget, 2007; The United Kingdom Parliament Report, 2007).

Moreover, Borselli (2011) concluded that the average of MITC frauds with respect to the UK VAT gap over the period 2000-2010 ranges between 11% and 19,4%. Applying these percentages to the overall EU-27 VAT gap in 2009 we get an estimate of an annual amount of MITC frauds ranging between €13 and €23 billion.

For the last decade, in the UK, levels of MITC fraud have risen since it was identified and measured between 2000 and 2010 (HM and Revenue Customs Report, 2011). However, like any criminal activity its nature makes it difficult to measure, Table 1 below, presents this type of fraud with a variety of different estimates of the size of the activity. MITC fraud impact on VAT receipts ranged from £0,5 billion to £3,5 billion whereas over the same period the percentage of MITC fraud in relation to the overall VAT gap ranged between 8,8% and 22,9%. It is crucial to conclude that the percentage of VAT fraud in relation to VAT gap has declined dramatically over this ten year horizon.

Table 1. MITC Fraud Estimates

Year	**MITC fraud and % of VAT gap**
2000/2001	18%
2001/2002	19%
2002/2003	16%
2003/2004	14,50%
2004/2005	15,50%
2005/2006	22,90%
2006/2007	17%
2007/2008	11%
2008/2009	10,50%
2009/2010	8,80%

Source: HM Revenue and Customs (2011)

3.2 Other European Union countries

VAT is a significant part of total revenue for the EU member states accumulating to 13 to 22 percent of total annual revenue (Brederode, 2008). Unfortunately, the current EU VAT system is extremely vulnerable with respect to MITC or carousel fraud. This vulnerability is primarily due to the fact that the exchange of information between member states of the EU is slow, often too slow to expose fraudsters before they have disappeared again as the fraudulent, fictitious companies set up by these malicious persons only exist for a period of between three and six months (Kerremans et al, 2005).

PwC in their report in September 2006 submitted evidence in relation to the carousel fraud within the EU. They have enlightened that carousel fraud has led to a number of outcomes that have a negative impact on the efficiency of the economy including the following: extra administrative burdens for both businesses and the tax authorities, delays in receiving legitimate VAT repayments as well as the creation of transactions with no economic benefits. After four years, by estimating the missing values for other EU countries and adjusting for 2009 calculated that the VAT gap for the EU-27 came to about €119 billion euro in the late 2009 (PwC report, 2010).

It has been declared that the explosion of carousel fraud is costing the EU the same as the total common agricultural policy spending, and even five times more than expenditure on employment and social affairs (G4S International, 2007). Anderson and Franzen (2008) went one step further to quarrel that carousel schemes deprive the Member States a great deal of tax revenues since investigations prove that up to 100 billion euro disappear every year.

These wider economic impacts, in addition to the misappropriation of government funds, create compelling reasons for the development of policies/proposals that will effectively deal with carousel fraud. The next sub-sections provide us with substantive evidence of distinct European countries and the impact of VAT carousel fraud to their economies. The list of countries can go on but the most critical cases were presented beneath.

3.2.1 Carousel fraud and Austrian economy

Every year, tax auditors detect cases of carousel fraud worth 50 to 100 million euro in revenue loss. If the goods that are traded in carousels actually find their way into normal sales outlets, the result is a distortion of competition, as such goods can be sold below customary prices since profits are made in the form of VAT received but not passed on to the tax office (Federal Ministry of Finance report, 2007).

3.2.2 Carousel fraud and Sweden economy

A report of the Swedish Tax agency published in October 2007 presented estimates of the overall tax gap in Sweden. According to these estimates, 26 per cent of the gap related to VAT where the VAT gap came to a level of around SKR 35 billion; this contrasts with the considerable lower top-down estimate of SKR 4.1 billion in 2001 and of SKR 1.6 billion in 2002.

3.2.3 Carousel fraud and German economy

Nam and Parsche (2007) estimated German VAT losses for the period 1997-2007. From their analysis they have reported that the VAT gap for 2005 was 17 billion euros, for 2006 15 billion euros and, for 2007 14 billion euros. It is important to perceive the decrease in the VAT gap for 2007 despite the increase in the German VAT standard rate from 16 to 19 percent from 1 January 2007.

It is clear that the German VAT compliance landscape has changed dramatically the last years as the German enforcement is far more stringent than in other countries (Ainsworth, 2011).

3.2.4 Carousel fraud and French economy

The French Auditors report (2007) on tax fraud integrated new estimates obtained by extrapolating data from inspections, using a stratified extrapolation method to reduce the bias due to risk-based targeting of inspections. The results of the report expose figures of 7.3 to 12.4 billion euro for VAT. As a matter of consequence from the VAT carousel fraud, the French balance of trade (exports minus imports) was overstated. The main reason for this effect is the fact that the measure of foreign trade transactions is based on VAT returns (Cachia, 2007).

3.3 Conclusive remarks

There needs to be an increasing global awareness of the term carousel (or MITC) fraud. It should be recognised as theft on a grand scale, not tax evasion, and therefore treated as a serious crime. The next section of this work recommends different proposals/measures to combat VAT carousel fraud.

4 Proposals to Counter VAT Carousel Fraud

4.1 Tackling VAT carousel fraud: Actions to date

As part of the wider international strategy, negotiations are continuing with European partners to secure derogation necessary to introduce new systems most commonly used to tackle VAT carousel fraud.

Inland Revenue's approach in the past years has focused on a 'means of knowledge' test involving extended verification; employees conducted lengthy and far-reaching enquiries into every constituent part of each transaction chain, examining whether frauds have occurred and whether other participants in the trail could have known of it (European Union Committee report, 2007).

Marquez (2010) has evaluated that it has long been one of the main goals of the tax commissioner to conquer tax fraud, particularly VAT carousel fraud. To avoid carousel fraud, a definite VAT system must be implemented based on the taxation of goods and services in the member state of origin.

While the above mentioned strategies are in operation, proposals have broadened to include co-operation with other EU Member States as well as advancement with the technological facets.

4.2 Effectiveness of existing measures to fight VAT Carousel fraud

Steve Botham, for the Institute of Chartered Accountants in Scotland (2007), put it to us succinctly that none of them were aimed at stopping the fraud as they were all aimed at making it more difficult to penetrate the fraud and further to pass the liability to other people who were dealing with fraudulent traders.

Summarising, it has been stated that VAT carousel (or MITC) fraud constitute the largest single source of fraudulent VAT losses for the Inland Revenue authorities. Fighting VAT fraud is the single gravest accession challenge to a country's customs administration. The government should remain determined to tackle VAT carousel fraud. Operational activities should be intensified throughout the countries and global co-operation should be set in motion. Additionally, the government should bring forward additional legislation for a more sophisticated VAT system that would entail to minimisation of this serious and intimidating VAT fraud.

4.3 Proposals to tackle VAT Carousel fraud

4.3.1 Proposals suggested by the EU Commission

According to the EU Commission , the preconditions for any change to the current VAT system are the following:

- reduce considerably the possibilities for fraud and exclude new important fraud risks;
- generate no disproportionate administrative burdens for traders and the authorities;
- ensure tax neutrality;
- ensure non-discriminatory treatment in a Member State between both national operators and operators established elsewhere.

Individual member states can act with these broad parameters in order to combat VAT carousel fraud. The use of derogation from the general principles of EU VAT law which the measures in the UK Finance Act 2006 rely on, provide an opportunity for Member States to combat carousel fraud in the short-term. The other strategies proposed by the EU Commission establish a framework to tackle the fraud more effectively in the future (UK Parliament report, 2007).

However, in the report of PwC (2006), it has been declared that the proposals of the EU Commission will be helpful but are likely to take time to implement, given the requirement for international agreement. Additionally, the Portuguese Tax Administration has carried out a study to analyse the impact of the proposed measures between companies. It was concluded that the implementation of these measures cause an overall negative impact, increasing the exposure to tax fraud risk due to the shifting of tax collection from large companies to small ones, which are more numerous and more difficult to control (Portugal Ministry of Finance and Public Administration, 2007).

Moreover, the European Commission on 28 January 2009, adopted a proposal to change the VAT Directive (2006/112/EC) in respect to the invoicing rules, based on a Communication on the technological developments in the field of electronic invoicing. The aim of the proposal is to increase the use of electronic invoicing, reduce burdens on business, support small and medium sized enterprises (SMEs) and help Member States to tackle fraud.

4.3.2 Generalised ‘ Reverse – charge’ system

A generalised reverse charge system would pass the liability for VAT on all transactions between businesses onto the buyer, rather than the seller. VAT would not change hands, and the buyer would be expected to account for the tax to the Inland Revenue authorities, and apply it as a credit against sales tax, where this would in effect replace VAT with a Sales Tax (Martin, 2007; Gosling, 2007).

According to the Commission, a reverse charge system provides advantages to Member states provided that it is applied in certain economic sectors only, such as construction and goods with high value added. This type of system increased the receipts of the Member States and most particularly Germany had the benefit of a 25 per cent reduction of VAT losses as well as Austria had enjoyed positive advantages via the use of the reverse-charge system in the area of the construction industry (International VAT Association report, 2007; IFS Green Budget report, 2007).

However, the difficulty of applying a limited reverse charge to certain products is that fraud would likely move onto other goods or services not covered by this system (ICAEW report, 2007). Furthermore, studies have shown that a Sales Tax is efficient at relatively low rates but is increasingly difficult to administer as rates rise (European Union Committee report, 2007). Cross-border trade would become more expensive as organisations would now pay the Sales Tax rate of the country of purchase. This mechanism can cause fraudsters to migrate to other sectors, notably retail, and is not likely a permanent solution (Madzharova, 2011).

The generalised reverse-charge generates far too high a level of risk for the receipts of the Member States, especially since the concentration of the tax and its payment takes place with the retailer (defaulting retailer). In the French report of the Conseil des Prelevement Obligatoires (2007), it was mentioned that tax evasion in a country such as the US applying a Sales Tax system, is estimated at about the level of 30 per cent. Extensive reverse charging might help to stem losses from VAT carousel frauds, but might expose the VAT to other risks of revenue loss through more mundane forms of evasion (Sinn et al, 2004; Keen and Smith, 2007; Tumbel, 2007). Consequently, it seems that this type of proposal is likely to cause greater tax evasion than a tax such as VAT.

4.3.3 Taxing intra-EU transactions

One of the key weaknesses in the present transitional system is the ability to purchase and sell goods and certain services intra-EU, tax free. This creates one of the key characteristics of the menacing carousel fraud, where the opportunity to claim fraudulent VAT refunds arises principally because of the break in the VAT chain that occurs as a result of the zero-rating of intra-EC exports.

Moreover, in a paper in the December 2006 National Tax Journal, Keen and Smith have agreed that a longer-run and durable solution to the problem of MITC fraud requires a fundamental redesign of the VAT treatment of international transactions. Ending VAT zero-rating for trade between EU member states would sharply reduce the scale of refunds and eliminate some of the most tempting opportunities for missing trader frauds.

In addition, it has been argued that the removal of the zero-rating of intra-EU supplies is one which appears to fulfill the basic requirements of simplicity, proportionately and legal certainty while maintaining the basis of a fractionated payment system (International VAT Association report, 2007).

On the contrary, Brever and Nam (2009) conferred that VAT fraud can be combat by taxing intra-community supplies at a common rate of 15% accompanied by the internal correction of input-tax gap between an importer and his own tax liability.

4.3.4 Fiscal Substitution

The method consists in choosing one of the economic operators in a chain as being the person legally liable for the payment of the VAT. This operator will request payment by his client of two amounts of VAT: The VAT ‘per se’ for the operation and the VAT for ‘fiscal substitution’.

The VAT per se is calculated based on the value of the operation between the person liable for the payment of the VAT and his client. Substitution VAT is calculated based on an ‘indicative value’. The VAT thereby obtained is deducted from the operator’s VAT per se. This difference will be paid by the client to the supplier and the supplier in turn pays the tax to the state. In the case of intra-community sales the supplier (liable for payment of the VAT) pays the VAT directly to the state of destination (International VAT Association report, 2007; European Union Committee report, 2007).

Despite the apparent benefits of this solution, it would require a fundamental change to the existing VAT system as it would require significant adaptation to the EU’s 27 Member States’ existing legislation and practices in order to operate within the EU.

4.3.5 VAT Grouping

Article 11 of Directive 2006/112/EC allows for Member States the possibility, after consultation with the VAT Committee to introduce into their VAT legislation a VAT Grouping measure allowing for taxable persons closely linked by economic or financial ties to be treated as a single taxable person (International VAT Association report, 2007). PwC report (2007) for the Commission on the taxation of Financial Services, illustrated that 86% of surveyed businesses are reluctant to outsource operations because of the potential VAT costs. If VAT grouping were made mandatory for Member states to introduce, this would reduce VAT flows between businesses and the inherent risks of fraud.

It should be renowned that EU agreed on a common payment system as it will make transfers across the EU cheap, easy and quick. The system will apply both within the eurozone and to non-euro member states as well as to those new member states that have not yet adopted the euro. Principles for a Payment Services Directive have been agreed by ministers to cover transactions conducted by businesses and individuals, whether made by credit or debit cards, electronic transfers, direct debit, standing orders or cheques (Gosling, 2007).

4.3.6 Cooperation between revenue services

The report by the Controller and Auditor General (2004) explained that one mechanism that facilitates VAT communication and coordination is a computerised system for automatically exchanging information about VAT registered traders and the value of their intra-Community supplies of goods, known as the VAT Information Exchange System or VIES.

Moreover, another technique except VIES to struggle VAT fraud was founded as 'Fiscalis 2007'. This technique is a multiannual activity program of the Committee meant to improve and coordinate the indirect taxation of the EU states, and to consolidate cooperation between member states. The goal of this method is adopting a structured approach allowing European system to function as one single administration in order to protect the financial interests of the Community by struggling against tax (Cinca, 2008).

The International VAT Association report (2007) focused on the solutions offered by enhanced administrative cooperation, concluding that there is ample scope for significant traction in the fight against fraud. The establishment of an internal market characterised by free movement of goods between Member states could not be guaranteed. Thus the harmonisation of turnover tax systems is identified as a priority (Ahmad and Faris, 2010).

However, EU expansion has made it politically more difficult to take further steps towards closer VAT coordination. Indeed tax matters including VAT continue to be subject to uniformity in the EU which means that every single one of the member states has a veto in the legislative process to make further changes to the EU VAT framework.

4.3.7 Technological strategies

Until 2006 no solution has been considered in relation to a technology based administrative proposal. Ainsworth (2008) initiated a proposal for a limited adoption of a digital VAT where it seeks digitisation and certification of the current system. He explained that under a certified tax software solution, enterprises would be able to (a) assure the tax authority that the VAT is properly assessed and collected and (b) minimise itself from cash flow or other losses arising from an audit or investigation based on suspected VAT MITC or carousel fraud (Ainsworth, 2010).

Additionally, China launched a major fiscal reform project called Golden Tax Project (GTP) which mandates the use of specific sophisticated information technologies to improve compliance with China's VAT laws. The Chinese policy requires the use of stronger central controls than the EU policy where the Chinese GTP strategy might provide a useful model for other developing countries struggling with large scale VAT compliance problems (Winn and Zhang, 2010).

Another report proposed an e-VAT where the essential advantage is that it facilitates automatic and electronic collection of the VAT. The report provided an explanation of how the e-VAT system would operate, achieve progressivity and deal with the problems of tax evasion (Goldberg, 2010).

5 Conclusion and Recommendations

In conclusion, the high and increasing levels of VAT fraud in the EU, and its movement into areas such as services, is beginning to affect Member states' international trade statistics and current account balances, the consequences of which require action on a determined and coordinated basis. Notwithstanding all the merits of the existing system, it is clear that something must be done in order to reverse the current trend. As Ligthart (2006) stated in his article, 'what is needed to combat VAT fraud is a complete overhaul of the VAT system'.

It is true that the common system of VAT is under sustained attack by fraudsters; there is a strong public interest in the proper administration and collection of tax and also in the prosecution of crime. However, the Achilles' heel for the fraudsters is the point at which the VAT is extracted. Any changes in the VAT system design need to be pursued through broad consensus. The overall picture is complicated by the unprecedented enlargement of the EU with the accession of new members with broadly varying levels of administrative capacity in handling conventional evasion and organised fraud. It is suggested that national authorities should consider how to implement and share best practice and profiles to combat VAT carousel fraud with other national governments.

Finally, no perfect system seems to exist that can work the miracle of distinguishing easily fraudsters from law law-abiding taxpayers and delivering deserved punishment on the ones while shielding the others from the tax authorities' errors of judgment. A trade-off is necessary between the interests of business and those of the administration, based on a clear understanding of its net benefit. An understanding between member states and European institutions is necessary to turn the balance into a clear benefit for everyone, not just for each member state, but also for enterprises and entrepreneurs acting within the EU.

An introduction of an EU modern IT management system is crucial. Cooperation among countries is imperative as it can reduce the level of the underground economy.

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