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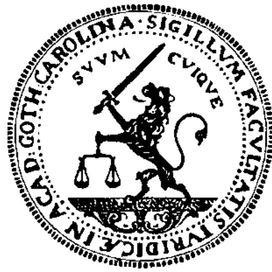

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Missing Trader Fraud in the EU

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Summary

The zero-rating of intra-Community acquisitions in combination with the deferred payment of VAT has made it possible to employ carousel fraud with VAT on the internal EU market. Not only are the tax authorities in the different Member States losing out on VAT that is not accounted for by missing traders, but the innocent parties in business with the missing traders retain a right to refund VAT, leaving the tax authority with a loss when refunding VAT that was never collected. Moreover, the carousel can theoretically keep turning an infinite amount of times and when a carousel is discovered, the people behind the company committing fraud are usually long gone.

Member States have been trying to stop the loss of VAT by turning on the innocent party of the business chain, intending to hold them liable for the missing VAT. However, this has been stopped by the ECJ on a number of occasions, as the Court in its judgments has protected the innocent party in good faith and thus upholding the fundamental principles of law, primarily the principles of legal certainty and proportionality.

The market for emission rights trading has been the primary target for VAT fraud in the last few years, mainly due to the high value of the emission rights and the fast pace of the trading on online exchange bourses. The EU has of late implemented temporary solutions in order to hinder the fraud on this market, yet the issue of VAT fraud as a whole remains to be solved.

Due to the political complications of creating a completely harmonised internal market within the EU, the otherwise most effective way of ending the VAT carousel fraud within the Union, other solutions are debated and investigated throughout the EU.

The most prominent idea is real-time VAT collection, using technological solutions to collect VAT right when a purchase is concluded. That way, companies are relieved of the VAT compliance burden, the tax authority will receive VAT right away and since no VAT is ever in the hands of anyone else than the competent authority, fraud is effectively stopped.

Sammanfattning

Nollbeskattningen av gemenskapsinterna förvärv i kombination med uppskjuten betalning av moms har möjliggjort karusellbedrägeri med moms på den EU-interna marknaden. Följaktligen har medlemsstaterna drabbas av utebliven moms som inte redovisas av ”missing traders”, samtidigt som den oskyldige affärspartnern till en ”missing trader” behåller sin rätt att återfå moms, vilket skapar en förlust för staten i fråga som får betala tillbaka moms som aldrig inkommit. Dessutom kan en momskarusell i teorin snurra oändligt många gånger och när en karusell upptäcks har personerna bakom företaget som begår bedrägeriet oftast sedan länge försvunnit.
Medlemsstaterna har försökt stoppa sina momsförluster genom att vända sig mot den oskyldige parten i transaktionskedjan, med avsikt att hålla denne ansvarig för den uteblivna momsen. Detta har dock EU-domstolen satt stopp för vid ett antal tillfällen. Domstolen har nämligen genom sina avgöranden skyddat den oskyldige parten som varit i god tro och därmed upprätthållit de grundläggande rättsprinciperna, främst principerna om rättssäkerhet och proportionalitet.
Handel med utsläppsrätter har drabbats hårt av momsbedrägeri de senaste åren, mestadels med anledning av det höga värdet på utsläppsrätterna och det höga tempot med vilket handel på onlinebörser sker. EU har den senaste tiden implementerat temporära lösningar för att stoppa bedrägeri på nämnda marknad, men problemet med momsbedrägeri i stort kvarstår.
På grund av de politiska komplikationerna med att skapa en helt harmoniserad intern marknad inom EU, vilket annars är det mest effektiva sättet att stoppa bedrägeri med momskaruseller inom Unionen, så debatteras och undersöks andra lösningar inom hela EU.
Den mest realistiska lösningen är momsbetalning i realtid, vilket innebär att momsen genom tekniska lösningar betalas samtidigt som en transaktion genomförs. På så sätt slipper företag hantera moms, skattemyndigheten mottar momsen direkt och eftersom ingen moms är i händerna på någon annan än kompetent myndighet är möjligheterna till bedrägeri utraderade.

Abbreviations

AG	Advocate General
B2B	Business-to-business
B2C	Business-to-Consumer
CMR	Waybill for consignments; based on the UN *Convention on the Contract for the International Carriage of Goods by Road*.
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council of the European Union
ECR	European Court Reports
EU	European Union
EUA	EU Emission Allowance
ETS	Emission Trading Scheme
HMRC	Her Majesty's Revenue and Customs
MTIC	Missing Trader intra-Community Fraud
QRM	Quick Reaction Mechanism
RCM	Reverse Charge Mechanism
RTvat	Real-Time VAT Collection
RVD	Recast VAT Directive
UK	United Kingdom
UN	United Nations
VAT	Value Added Tax
VIES	VAT Information Exchange System
VLN	VAT Locator Number

1 Introduction

1.1 Background

VAT fraud on intra-community trade, so called *missing trader fraud* or *carousel fraud*[1], is of great concern for the European Union. The abolition of fiscal frontiers within the EU in 1993, made it easier to commit carousel fraud, since all the internal boarder controls were removed.[2] Transported goods have thereafter only been subject to the administrative controls, but no physical control at EU's internal borders.[3]
In an investigation ordered by the European Commission, it was estimated that the VAT gap[4] in the EU was €106.7 billion in 2006.[5] Although this is not a completely reliable figure given the nature of fraud, the estimated lost VAT amounts to 12% of the theoretical VAT liability[6].[7]

One sector especially has been the target for VAT fraud in recent years, the trade with emission rights under the Emission Trading Scheme (ETS). Given that emission rights are intangible property, they are particularly exploitable for fraudsters. Transactions are concluded fast, without any transportation costs or other significant handling costs. When the ETS frauds were discovered in late 2009, Europol estimated that around €5 billion had been lost in the past 18 months.[8] Furthermore, it is believed that

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[1] For the purpose of this paper, *carousel fraud* will be used synonymously with missing trader fraud.
[2] Amand, Christian. – De Rick, Frederik: *Intra-Community VAT Carousels*, VAT Monitor Jan/Feb 2005, page 8.
[3] Amand, Christian. – De Rick, Frederik: *Intra-Community VAT Carousels*, VAT Monitor Jan/Feb 2005, page 8.
[4] The VAT gap is the same as the VAT lost to fraud.
[5] DG Taxation and Customs Union, Report 21 September 2009, *Study to quantify and analyse the VAT gap in the EU-25 Member States*, Reckon LLP, page 8.
[6] The theoretical VAT liability is the VAT that would have been collected if there was no fraud.
[7] DG Taxation and Customs Union, 2009, page 9.
[8] Europol press release 9 December 2009, *Carbon Credit Fraud Causes more than 5 Billion Euros Damage for European Taxpayers*. Note that this is an estimation made by Europol and that there is no confirmed statistics available.

domestically up to 90% of the trades in carbon credits were caused by fraud.[9]

As the values lost by tax authorities in the EU to VAT fraud is so immense, the EU is working hard on a solution to the problem. Possible solutions to the problem include the quick reaction mechanism, the reverse charge mechanism, structural changes to the VAT system and technological solutions.

1.2 Purpose

As the legislators work to combat VAT fraud, the methods and schemes used by the fraudsters become all the more intricate and branches out into new vulnerable markets.

The aim of this paper is to investigate the missing trader fraud in the EU in general and on the market for emission rights in particular. What makes missing trader fraud possible under the current VAT Directive and how is it conducted? Why has the ETS been so heavily targeted for VAT fraud? How has the case law from the European Court of Justice affected the attempts to stop carousel fraud?
Lastly, possible solutions to the great problem of VAT fraud will be addressed. Is there a means available to stop fraud within VAT, either through legislation, technology or can the goal be achieved through a combination of the two?

1.3 Method and Material

The method used in this paper will be a legal dogmatic method, primarily using laws, case law, preparatory work and doctrine as sources for the investigations. The most important case law will be discussed under a

[9] Europol press release 9 December 2009, *Carbon Credit Fraud Causes more than 5 Billion Euros Damage for European Taxpayers*. Note that this is an estimation made by Europol and that there is no confirmed statistics available.

separate section. However, cases will also be referred to under each section insofar as it is relevant. There will be comments and discussions continuously throughout the paper. Yet the main analysis and conclusion will be left to the end of the thesis.

This thesis is directed to readers with a good understanding of VAT and how the EU VAT system works. Therefore, fundamental parts of the VAT system will not be explained in detail, nor will the terminology in most cases.

1.4 Delimitation

Due to the vastness of the area of VAT fraud, it is not possible to cover all the different types of VAT fraud in this paper. Focus will thus be on the missing trader fraud in intra-community trade. Other types of VAT fraud, including international and purely domestic VAT fraud will be outside the scope of this thesis.[10]

The paper will primarily be written from an EU perspective. Notwithstanding, some of the Member States actions against, and experience of, VAT fraud will be drawn upon when suitable.

[10] Other types of VAT fraud include for example deducting VAT on goods for private use or incorrect reporting of VAT to the authorities.

2 Missing Trader Fraud

2.1 The Carousel

The basic model for carousel fraud involves three different companies located in two different member states. Company (A) located in Member State (1) sells goods to company (B) in Member State (2). This is a zero-rated intra-community supply from (A), hence no VAT.[11] Company (B) makes a regular domestic supply of the goods (charging VAT) to company (C).[12] Company (B) does not account for the VAT to the tax authorities, but disappears (i.e. the missing trader). Company C has a right to a refund from the tax authority of the VAT paid to company (B). Hence, the tax authority loses money when refunding company (C) VAT whilst not receiving any VAT from company (B).[13]

For this to be a *true* carousel, company (C) sells the goods back to the original seller, Company A in Member State (1); the carousel can then be repeated infinitely.[14]

It is not uncommon for VAT carousels to include so-called "buffers" or "buffer companies" within the transaction chain in order to complicate the structure and delay investigations from the authorities.[15] The buffer companies may or may not know that they are part of a carousel fraud. The chain of transactions can be made more intricate by adding more buffers spread over more Member States.[16] By the time the authorities realise there

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[11] RVD Art. 138(1).
[12] RVD Art. 2(1)(a).
[13] Memo/12/609, *VAT: Commission proposes new instrument for speedy response to fraud – frequently asked questions*. European Commission Memo 31/07/2012.
[14] Terra, Ben. – Kajus, Julie: *A Guide to the European VAT Directives*, Amsterdam 2012, p. 339.
[15] Swinkels, Joep: *Carousel Fraud in the European Union*, International VAT Monitor Mar/Apr 2008, p. 104.
[16] Swinkels, Joep: *Carousel Fraud in the European Union*, International VAT Monitor Mar/Apr 2008, p. 104.

is a VAT fraud carousel, the company which collected undue VAT has often disappeared, ergo the "missing trader".[17]
A carousel like the one in *Supplement 1* could, theoretically, have the same goods go around infinite times. In this scenario, the Swedish tax authority is making a real loss of 23.75 for every turn of the carousel. That is the amount refunded to company C, the broker, and which the missing trader, company B, has neglected to report in. Hence missing trader fraud does not cost the tax authority in terms of a lost income of tax, but as an actual payout. Consequently, it is much more costly than for example a small domestic trader not reporting the correct amount of VAT. Such a situation will cost the tax authority since the correct amount of tax is not levied from the end consumer; or rather, the vendor keeps some of the VAT for himself, i.e. the *revenue* received by the tax authority is less than it should be. Comparing this to a VAT carousel fraud, the carousel not only means that *no* VAT at all is paid in (whereas most of the VAT is paid in the example with the small vendor) but also the tax authority has to *refund* VAT even though none has been paid in. This gives a double loss in a sense, both missing VAT revenue *and* refunding the VAT that was never received.
Furthermore, once the carousel fraud is discovered and company B is missing, the money lost is very hard for the tax authorities to recover; company C is innocent and has no responsibility for the trade with the missing trader in terms of the VAT refunded.[18]

Due to the nature of carousel fraud, goods circulating between companies and member states, the goods used in these schemes are preferably small but with a high value. This makes them easier and more inexpensive to transport. Typically, fraudsters have used mobile phones, computer chips or similar.[19] However, there have been cases involving for example cars[20] and,

[17] See Supplement 1 for an example of a simple VAT carousel.
[18] The innocent party is in some cases liable for the VAT embezzled by the missing trader according to the ECJ. This is discussed in depth under 2.2 ECJ Case Law.
[19] Memo/09/423, *Commission proposal on temporary measures for a consistent response to carousel fraud in certain sectors – Frequently Asked Question*. European Commission Memo 29/09/2009.
[20] See 2.2.3 *Kittel and Recolta*

as will be expanded upon later[21], even tradable services[22] in the form of emission rights.

The benefit of using goods of a high value is evident when looking at the example above. The VAT is a percentage of the price of the goods, hence the higher the value, the more VAT there is to steal.

2.2 ECJ Case Law

This section will look into the most prominent cases on MTIC from the Court of Justice. It is not meant to be an exhaustive recapitulation of the Courts decisions on the topic of VAT fraud. The cases will be handled chronologically in order to provide the evolution of the ECJ case law on this area. Only cases relevant to this thesis will be included.

Regarding carousel fraud, the questions that have reached the Court of Justice have primarily been concerned with the liabilities for the innocent party. The rights and obligations of the innocent party involved in business with a fraudster will be the key issue of this chapter; however, this will also be connected to what Member States are allowed to do in order to prevent VAT fraud.

2.2.1 Optigen, Fulcrum and Bond House Systems

In the joined cases of Optigen, Fulcrum and Bond House Systems[23] (hereafter *Optigen*) the question before the Court was, in essence, whether or not the activity carried out in a carousel fraud was to be considered as an economic activity or not, i.e. a supply of goods or services within the scope of the RVD.[24]

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[21] See 3. Carousel Fraud in the Emission Trading Scheme

[22] Tradable services are, on the contrary of regular (consumed) services, not consumed upon purchase but can be re-traded. In that sense tradable services have the characteristics of goods.

[23] Case C-354/03 (*Optigen and Others)* [2006] ECR I-00483.

[24] RVD Art 2(1).

The companies in *Optigen* were innocent parties involved in a VAT carousel; Her Majesty's Revenue and Customs (HMRC) was of the opinion that all transactions in a chain linked to VAT (carousel) fraud should be treated as one. Consequently HMRC argued that the whole chain was noneconomic in nature, thus outside the scope of VAT. This meant that companies involved lost their right to deduct or reclaim VAT.

According to AG Maduro in his opinion on the case, since VAT becomes chargeable on every transaction, the transactions must be regarded individually; ergo "the character of a particular transaction in the chain cannot be altered by earlier or subsequent events".[25]

The ECJ also disagrees with HMRC, clarifying that "the scope of the term economic activity is very wide and […] objective in character in the sense that the activity is considered per se and without regard to its purpose or result"[26]. Furthermore, the ECJ also disqualifies the notion that the whole chain should be outside the scope of VAT due to being illegal. The transactions made by companies that did not know and had no means of knowing that they were involved in the same chain as a fraudulent party still fulfil the criteria for taxable transactions within the RVD.[27]

The way the ECJ stipulates that the involved parties had no knowledge of the fraud can be interpreted as requiring an absence of *mala fides* from the companies.[28]

2.2.2 Federation of Technological Industries

In *Federation of Technological Industries*[29], decided by the Court just a few months after *Optigen*, the UK was involved once again. This time it was regarding whether or not legislation making companies with *mala fides* jointly and severally liable for payment of the VAT embezzled from their transaction chains. In that sense, the case is a continuation of *Optigen* where the ECJ seemed to open up for such an interpretation.

[25] Opinion of Mr Maduro – Case C-354/03 paragraph 27.
[26] Case C-354/03 (*Optigen and Others)* [2006] ECR I-00483. Paragraph 43.
[27] Case C-354/03 (*Optigen and Others)* [2006] ECR I-00483. Paragraph 51.
[28] van Brederode, Dr. Robert F: *Third-Party Risks and Liabilities in Case of VAT Fraud in the EU,* International Tax Journal Jan/Feb 2008, p 34.
[29] Case C-384/04 (*Federation of Technological Industries*) [2006] ECR I-04191.

Firstly, the Court discusses if such legislation is compatible with the RVD and finds no objections on that basis. However, such legislation must also be compliant with the general principles of law, more specifically the principles of legal certainty and proportionality in this case.[30]

In essence, the court concludes that it is allowed for Member States "to enact legislation [...] which provides that a taxable person, to whom a supply of goods or services has been made and who knew or had reasonable grounds to suspect, that some orall [sic] of the VAT payable in respect of that supply, or of any previous or subsequent supply, would go unpaid, may be made jointly and severally liable, with the person who is liable, for payment of that VAT. Such legislation must, however, comply with the general principles of law which form part of the Community legal order and which includes, in particular, the principles of legal certainty and proportionality."[31]
Even though the Court did not accept the legislation in this particular case, it gives the possibility for Member States to implement similar legislation as long as it is compliant with the general principles of law. To what extent it is actually possible to create a legislation both inferring joint and several liability whilst upholding the principles of legal certainty and proportionality remains to be seen.

2.2.3 Kittel and Recolta

Joined cases *Kittle and Recolta*[32] (henceforth *Kittle*) developed the ECJ's case law on third party liabilities when involved in a fraudulent transaction chain further. In sum, it is a clarification of the Court's jurisprudence from the *Optigen* and *Federation of Technological Industries* cases. The Court also starts out by citing *Optigen* to reiterate the width of the scope of VAT

[30] Case C-384/04 (*Federation of Technological Industries*) [2006] ECR I-04191. Paragraphs 29 and 30.
[31] Case C-384/04 (*Federation of Technological Industries*) [2006] ECR I-04191. Paragraph 35.
[32] *Axel Kittel v Belgian State* and *Belgian State v Recolta Recycling SPRL* (Joined Cases C-439/04 and C-440/04) [2006] ECR I-06161.

as well as what is "economic activities".[33] *Optigen* is then a continuous point of reference throughout the case, especially in the context of protecting traders acting in good faith. *Federation of Technological Industries* is also referred to when the Court states that "traders who take every precaution which could reasonably be required [...] to ensure that their transactions are not connected with fraud, [...] must be able to rely on the legality of those transactions without the risk of losing their right to deduct input VAT."[34] In the question of bad faith however, the ECJ extends the previous responsibility of such traders, stating that if there is bad faith the company is to "be regarded as a participant in that fraud, regardless of whether or not he profited [from it]."[35] In such a case, traders in bad faith are viewed upon as an accomplice.[36]

In conclusion, *Kittle* makes the question of good or bad faith of the (innocent) trader the key issue in allowing or refusing said trader, involved in a chain containing VAT fraud, the right to deduct his input VAT. This widens the VAT obligations for traders, making them to some extent liable for not only their own VAT, but their business partner's VAT too. For there to be bad faith, it is enough that the innocent trader *should* have known. There is thus no requirement of *actual* knowledge.

2.2.4 Mahagében Dávid

The two joined cases *Mahagében and Dávid*[37] are mainly concerned with companies' obligation to investigate their business partner in order to avoid taking part in carousel fraud.

Mahagében was accused of falsifying invoices in order to refund undue VAT. During an inspection, the tax authority found that there was, for

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[33] *Axel Kittel v Belgian State* and *Belgian State v Recolta Recycling SPRL* (Joined Cases C-439/04 and C-440/04) [2006] ECR I-06161. Paragraphs 40 and 41.

[34] *Axel Kittel v Belgian State* and *Belgian State v Recolta Recycling SPRL* (Joined Cases C-439/04 and C-440/04) [2006] ECR I-06161. Paragraph 51.

[35] *Axel Kittel v Belgian State* and *Belgian State v Recolta Recycling SPRL* (Joined Cases C-439/04 and C-440/04) [2006] ECR I-06161. Paragraph 56.

[36] *Axel Kittel v Belgian State* and *Belgian State v Recolta Recycling SPRL* (Joined Cases C-439/04 and C-440/04) [2006] ECR I-06161. Paragraphs 57.

[37] *Mahagében Kft v Nemzeti Adó- és Vámhivatal Dél-dunántúli Regionális Adó Főigazgatósága* and *Péter Dávid v Nemzeti Adó- és Vámhivatal Észak-alföldi Regionális Adó Főigazgatósága* (Joined Cases C-80/11 and C-142/11) [2012] Not Yet Published.

several reasons, no possibility that the amount of timber reportedly sold had actually been delivered. The company had documentation stating otherwise. The company was nonetheless refused deduction of VAT because the issuer of the invoice did not enter the purchase of the goods concerned in its accounts, and that, without a lorry, it was unable to deliver the goods, even though it stated that it had supplied the goods and met its obligations as to declaration and payment of the tax. The question before the court was whether or not it was enough that a taxable person fulfilled the material conditions for deducting VAT, or if the tax authority could demand some objective proof of the transactions actually taking place.

Dávid was a similar case; a contractor had used a subcontractor, the subcontractor did not have any registered employees. Hence the tax authority found the invoice could not be adequately established and VAT thus not deducted. Another subcontractor had also been used by Dávid, but was now in liquidation and no records could be found.

In essence, the court discusses how far Member states may go when using compliance, in particular the control of a business partner, as a means to stop fraud. The conclusion is that they cannot enforce upon companies a so far reaching obligation to investigate the honesty of the operations of the companies they conduct business with as the tax authorities try to claim. Ergo, the right to deduct VAT cannot be denied companies as in these two cases.

The Court continues to follow its own jurisprudence; good faith will suffice for companies to remain entitled to deduct VAT irrespective of involvement in VAT fraud. Furthermore the companies were not deemed to be in bad faith because they should have known about the fraud; the possibility for which was opened for in *Kittle* and discussed above.

2.2.5 Mecsek-Gabona

The Hungarian company *Macsek-Gabona*[38] had sold rapeseed to an Italian company under the VAT exempt intra-Union supply regime. However, it turned out later that the Italian company had been a “fake” company; its registered address was a person’s home and the Italian company had never paid any VAT. Consequently, its VAT number was removed with retroactive effect. On the basis of all that information, the first-level Hungarian tax authority took the view that Mecsek-Gabona had not succeeded in proving, during the fiscal procedure, that the transaction in issue was a VAT-exempt intra-Community supply of goods, thus incurring a penalty for late payment of VAT along with a tax debt. Mecsek-Gabona claimed to be entitled to exemption from VAT on the basis of (i) the VAT identification number assigned to the purchaser by the Italian tax authority, (ii) the fact that the goods sold had been picked up by foreign-registered vehicles and (iii) the CMRs returned by the purchaser from its address, indicating that the goods had been transported to Italy.

The Court came to the conclusion that it is indeed possible for tax authorities to refuse the right to a VAT exemption on an intra-Union supply provided that it has been established, on the basis of objective evidence, that the vendor has failed to fulfil its obligations as regards evidence, or that it knew or should have known that the transaction which it carried out was part of a tax fraud committed by the purchaser, and that it had not taken every reasonable step within its power to prevent its own participation in that fraud.

It is not however, possible to refuse the vendor this VAT exemption solely on the grounds that another Member State’s tax authority has retroactively removed the purchaser’s VAT number.

The principle of legal certainty is once again prevailing as legal certainty is shown to be more important than protecting a Member States tax base. It is

[38] *Mecsek-Gabona Kft v Nemzeti Adó- és Vámhivatal Dél-dunántúli Regionális Adó Főigazgatósága* (Case C-273/11) [2012] Not Yet Published.

of course more or less impossible for a company to foresee the retroactive removal of a business partner's VAT number. The conditions for legislation on refusal of VAT deduction due to involvement in fraudulent business chains laid out by the Court in *Federation of Technological Industries* are not fulfilled in this case, nor were Macsek-Gabona in bad faith regarding the false VAT number or the trade as a whole.

Both *Teleos*[39] and *Netto*[40] are of similar nature to *Mecsek-Gabona*; sales were made exclusive of VAT based on falsified documentation stating the trade was either an intra-community acquisition (*Teleos*) or export (*Netto*). Moreover, the sales were seemingly made ex-works in all three cases. *Teleos* and *Netto* were both in good faith according to the Court.
It is worth noting that the ECJ does not discuss an extended liability to make sure the goods actually leave the Member State for these companies, regardless the sale is made ex-works. Given that the purchaser under such an incoterm picks up the goods at the sellers warehouse, it has all the characteristics of a domestic purchase. Since the seller delivers the goods domestically, yet invoices without VAT as an intra-Community sale, it would not seem unreasonable to extend his obligations insofar to ensure the goods are actually transported out of the Member State. If satisfactory proof cannot be provided by the purchaser, the seller can handle the transportation himself or simply add VAT to the invoice and report it as a domestic sale of goods. The customer can apply for the VAT back from the competent authority.

2.2.6 Summary

In many of the hitherto discussed cases from the ECJ, the Court narrows the Member States possibilities to implement measures to counter VAT fraud. All transactions in a transaction chain are regarded individually as far as

[39] *The Queen, on the application of Teleos plc and Others v Commissioners of Customs & Excise* (Case C-409/04) [2007] ECR I-07797.
[40] *Netto Supermarkt GmbH & Co. OHG v Finanzamt Malchin* (Case C-271/06) [2008] ECR I-00771.

VAT is concerned (*Optigen*), implementing legislation for joint and several liability cannot interfere with the fundamental principles of law, especially legal certainty and proportionality (*Federation of Technological Industries*). As long as companies are in good faith they are not liable for fraud within their transaction chains (*Kittle*) and companies have a very limited obligation to investigate their business partners and their transactions after sales (*Mahagében Dávid* and *Mecsek-Gabona*).

These cases will of course affect the way the EU and different Member States work towards a solution to the problem of MTIC. The one solution predominantly used until now, going after the companies in business with fraudsters, is seemingly inadequate. Furthermore, it is to a large extent prohibited by the ECJ, as the case law has shown.

There are different ways to counter VAT carousels. These will be discussed in length later.

3 Carousel Fraud in the EU Emission Trading Scheme

3.1 Background

The greenhouse effect and the danger of climate change caused primarily by the emission of greenhouse gases were tackled on an international scale for the very first time under the Kyoto Protocol. The Kyoto Protocol was signed on 11 December 1997.[41] When Russia ratified the protocol 18 November 2004, the ninety days countdown commenced and on the 16 February 2005 the protocol became binding in force for its 128 parties.[42] Russia's ratification fulfilled the prerequisites for the implementation. No less than 55 of the Parties to the Convention, together accounting for at least 55 % of the total carbon dioxide emission of 1990, had to ratify before it would enter into force.[43]

The European Union ratified the Kyoto Protocol on behalf of its Member States in 2002.[44] Furthermore, the EU opted to use the possibility of joint fulfilment available in the Kyoto Protocol.[45] In essence, this means that the EU has a joint responsibility to fulfil the targeted reductions of carbon emissions. As a consequence, the EU could redistribute the burden of reducing greenhouse gas emission between Member States. This redistribution of total emission allowed for each Member State was done through the Commission Decision 2006/944/EC.[46] The modified targets set

[41] Article 28, Kyoto Protocol to the United Nations Framework Convention on Climate Change.
[42] United Nations Press Release (UNFCCC secretariat), *Kyoto Protocol to enter into Force 16 February 2005*.
[43] Article 25, Kyoto Protocol.
[44] Council Decision of 25 April 2002 concerning the approval, on behalf of the European Community, of the Kyoto Protocol to the United Nations Framework Convention on Climate Change and the joint fulfilment of commitments thereunder. 2002/358/EC.
[45] Article 2 Council Decision 2002/358/CE and Article 4 Kyoto Protocol.
[46] Commission Decision of 14 December 2006 determining the respective emission levels allocated to the Community and each of its Member States under the Kyoto Protocol pursuant to Council Decision 2002/358/EC. This was later amended in Commission

for each Member State are based on each states relative wealth at the time of the agreement.[47] Moreover, the amended targets for each Member State are binding under EU law.[48]

The Kyoto Protocol allows the trading of emission rights between Member States.[49] The EU has capitalised on this possibility, creating an internal market for the trading of emission rights between companies in different Member States.

3.2 The EU Emission Trading Scheme

The Emission Trading Scheme (ETS) is fundamental in the EU's strive to combat climate change and fulfil the emission reduction targets set out by the Kyoto Protocol. It serves to reduce the amount of greenhouse gases emitted as well as redistributing the emission allowances between companies depending on need.

The ETS is based upon a so-called "cap and trade" principle, limiting the total amount of greenhouse gas emissions within the Union in a year with a cap.[50] The emission rights are tradable valuables, allowing the holder to emit on tonne of carbon dioxide, however, the allowances can only be used once and allowances have to be handed in to match the yearly emissions by a company.[51] All emissions need to be covered by emission rights; if a company has insufficient amounts of emission rights it will be fined heavily.[52]

By creating valuables of the carbon emissions, the companies involved in such emissions are forced to recognise the economical impact of the same; the environmental impact of companies' emissions are prioritised due to its

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Decision of 15 December 2010 amending Decision 2006/944/EC determining the respective emission levels allocated to the Community and each of its Member States under the Kyoto Protocol pursuant to Council Decision 2002/358/EC.

[47] European Commission <http://ec.europa.eu/clima/policies/g-gas/kyoto/index_en.htm>

[48] European Commission <http://ec.europa.eu/clima/policies/g-gas/kyoto/index_en.htm>

[49] Article 17, Kyoto Protocol.

[50] *The EU Emissions Trading System (EU ETS)*, Factsheet from the European Commission 2013, page 2.

[51] *The EU Emissions Trading System (EU ETS)*, Factsheet from the European Commission 2013, page 2.

[52] *The EU Emissions Trading System (EU ETS)*, Factsheet from the European Commission 2013, page 2.

economic significance. Hence, the EU (and indirectly the Kyoto Protocol) drives the development of carbon-efficient technology and low-carbon solutions forward.[53] The environment is otherwise usually neglected by companies, striving primarily towards low production costs and not environmentally neutral solutions and the emission allowances work as a means to force their hands.

3.3 VAT on Emission Allowances

The European Commission in its VAT guidelines for emission rights explains that "the transfer of greenhouse gas emission allowances [...] when made for consideration by a taxable person is a taxable supply of services falling within the scope of Article 9(2)(e)[54] of Directive 77/388/EEC. None of the exemptions provided for in Article 13[55] of Directive 77/388/EEC can be applied to these transfers of allowances."[56]

Therefore, the seller will only charge VAT on sales of an EU emission Allowance (EUA), if the supply is to a domestic company. If the EUA is instead sold to a company in another Member State, the sale will be considered an intra-community supply and it is taxable where the recipient company has domicile. The recipient will in such a case be responsible for accounting for the VAT to the authorities.

3.4 VAT Fraud on the EU Emission Trading Scheme

The targeting of the ETS for VAT fraud is due to a number of factors. Firstly, the emission rights are intangible, consequently not in need of any transportation when sold. Secondly, the EUA's are of high value, usually between €10 and €30, and all that is needed to trade with the EUA's is a

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[53] European Commission < http://ec.europa.eu/clima/policies/ets/index_en.htm>
[54] Article 56 RVD.
[55] Articles 131 through 137 RVD.
[56] TAXUD/1625/04 Rev.1 - Working paper n° 443 Rev.1, Commission guidelines on the application of VAT to emission allowances.

computer.[57] Lastly, the trades on the EUA's transactions platform are cleared within fifteen minutes, making the trades very rapidly completed.[58] Most importantly however, the VAT treatment of EUS's is the same as for goods on intra-community trade.[59] This opens up for MTIC schemes. The VAT carousel used is the same as the one described under 2.1. However, the supply is more or less instant, on the contrary to the regular VAT carousel, since the goods are traded directly on the digital exchange platform. The use of the exchange platform for the trade makes the VAT fraud even harder to uncover.[60] In 2011, around six billion emission allowances were traded on the EU carbon market amounting to a total value of €77 billion.[61]

The complications facing the authorities, when trying to find the fraudulent trades on such a vast market, moving assets at such a high speed, are evident.

When rumours surfaced in mid 2009 that the trading on the Bluenext[62] carbon exchange was driven by VAT carousel fraud, French authorities closed the exchange immediately. Moreover, before allowing it to open up again, the French authorities modified the domestic VAT regulations with regards to the EUA's; domestic trades were henceforth exempt supplies for VAT purposes.[63] This effectively stopped any VAT carousels in France from claiming undue VAT. When the exchange was once again opened, the daily number of EUA's traded dropped significantly, ending up at 85% less than before the exchange closed.[64]

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[57] Frunza, Marius-Cristian and others: *Missing trader fraud on the emission market*, Journal of Financial Crime Vol. 18 No. 2, 2011 p 186.

[58] Efstratios, Pourzitakis: *Halting the Horse: EU Policy on the VAT Carousel Fraud in the EU Emission Trading System*, EC Tax Review 2012/1 p 43.

[59] See 3.2 *VAT on Emission Allowances*.

[60] Efstratios, Pourzitakis: *Halting the Horse: EU Policy on the VAT Carousel Fraud in the EU Emission Trading System*, EC Tax Review 2012/1 p 44.

[61] *The EU Emissions Trading System (EU ETS)*, Factsheet from the European Commission 2013, page 6.

[62] Bluenext was a carbon exchange bourse in Paris.It was closed down in December 2012. *NYSE Euronext to Shut Carbon Market after Failed Auction Bid*. <http://www.bloomberg.com/news/2012-10-26/bluenext-carbon-exchange-to-shut-after-losing-eu-auction-bid-1-.html> accessed 2013-05-13.

[63] Kogels, Han: *VAT Fraud with Emission Allowances Trading*, EC Tax Review 2010-5 p 186.

[64] Nield, Kathrine. – Pereira, Ricardo: *Fraud on the European Union Emission Trading Scheme: Effects, Vulnerabilities and Regulatory Reform*, European Energy and Environmental Law Review Dec 2011 p 258.

Interim measures for dealing with the MTIC on the ETS were also implemented by other Member States. The solutions differed between the Member States; the Dutch implemented a reverse charge mechanism, leaving the recipient liable for VAT on emission rights, applicable both on intra-community and domestic transactions.[65]

In the UK, HMRC adopted a zero-rating of the supply of carbon credits domestically "to remain in force until an EU-wide solution is implemented".[66] The treatment of cross-border supplies was not changed. HMRC tries to justify the implemented measures, claiming that "Although there is currently no specific provision in EU law to introduce this measure, the UK Government believes that it is in the public interest that steps be taken now to prevent substantial potential losses to the Exchequer and to ensure that the legitimate market is not undermined by fraudulent trading."[67]

Romania had quite a different approach to solving the MTIC on emission rights, making trade with EUA's legal only on the Romanian capital market, hence forcing traders to register on the capital market and comply with the local provisions.[68]

Other Member States[69] followed and implemented different temporary solutions to the MTIC with carbon emission allowances.[70]

As was made clear by HMRC, the implementations made by Member States in order to combat VAT fraud with emission rights had no legal support in the RVD. Nonetheless it was deemed so important by the Member States they took measures regardless.[71] The EU was never going to take action against the illegality of the Member States' provisions, on the contrary the EU acted in order to amend the RVD in a way that would allow the Member

[65] Efstratios, Pourzitakis: *Halting the Horse: EU Policy on the VAT Carousel Fraud in the EU Emission Trading System*, EC Tax Review 2012/1 p 44.

[66] Revenue & Customs Brief 46/09 <http://www.hmrc.gov.uk/briefs/vat/brief4609.htm> accessed 2013-05-05.

[67] Revenue & Customs Brief 46/09 <http://www.hmrc.gov.uk/briefs/vat/brief4609.htm> accessed 2013-05-05.

[68] Efstratios, Pourzitakis: *Halting the Horse: EU Policy on the VAT Carousel Fraud in the EU Emission Trading System*, EC Tax Review 2012/1 p 45.

[69] E.g. Spain, Denmark, Belgium, Germany and non-EU member Norway to name a few.

[70] Wolf, R.A: *VAT Carousel Fraud: A European Problem from a Dutch Perspective*, INTERTAX Volume 39, issue 1 p 30-31.

[71] Measures were taken not only by the abovementioned Member States

States' provisions. Through the Directive 2010/23/EU[72] which came into force on 5th April 2010, the RVD was amended as a step in the combat against VAT fraud on carbon carousels.

In a newly inserted Article, Member States are allowed to implement a reverse charge mechanism for allowances to emit greenhouse gases.[73] This article is temporary and will only apply until 30 June 2015.[74]

It is clear that the EU has implemented this provision in order to give itself time to create a more sustainable solution to the problem. Hence the limited time it is applicable for and the electiveness of the provision. It is noticeable that it took the Council almost one year to put this amendment into action. Naturally, the Member States could not afford to wait for the EU to act if the time frame was expected. However, the opposite could be the case; the EU took its time since the Member States already had provisional solutions implemented.

Lastly, why has the EU made it optional for Member States to implement this anti-fraud measure? A temporary mandatory reverse charge on trade with carbon emission allowances would have effectively stopped the carousels on this market until another solution could be found by the EU. Instead, the RVD opens up for each Member State to implement a reverse charge mechanism in a way it sees fit. Rules will not only be incoherent across the Union, but might be non-existent in some Member States who opt not to employ reverse charge on carbon emission rights at all.

Already in 2008, Germany and Austria proposed a general reverse charge of VAT to the European Commission, as a means to combat VAT fraud in general.[75] The Economic and Financial Affairs Council of the European Union (ECOFIN) agrees that "the introduction of a generalised reverse charge would substantially reduce MTIC fraud as well as other types of

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[72] Council Directive 2010/23/EU of 16 March 2010 amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain services susceptible to fraud, Official Journal of the European Union, 2010-03-20, L72/1.

[73] Article 199(1)(a) RVD.

[74] Article 4, Directive 2010/23/EU.

[75] Kogels, Han: *VAT Fraud with Emission Allowances Trading*, EC Tax Review 2010-5 p 186.

deduction fraud".[76] However, the negative consequences of a general reverse charge outweigh the positive consequences according to the ECOFIN: "the reverse charge would be a fundamentally different system to the one currently applied. It would necessitate the definition of a second system at an EU level and thus have negative consequences on operation of the internal market; it also would undermine harmonisation and possibilities for future improvement of the VAT system. In addition, the optional character of a generalised reverse-charge system has been identified as a cost factor for businesses and as one of the main factors creating risks of new types of fraud within the EU."[77]

In sum, the ECOFIN's recommendation to the Council and European Parliament in this matter is "that a general reverse-charge system should either be introduced on a mandatory basis throughout the EU or be disregarded as a concept."[78] Noticeably, the exact opposite of this recommendation was implemented as the temporary solution to MTIC with emission rights, as seen above.

In addition, when the Directive 2010/23/EU implemented the optional reverse charge for EUA's, the scope of the Directive was not as wide as the European Commission proposed it should be. Other goods believed to be heavily targeted by VAT fraud was recommended to be included under the optional reverse charge mechanism, such as mobile phones, certain computer parts, perfume and some valuable metals.[79] The issue with VAT fraud on those goods was thus not solved by the EU's temporary Directive.

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[76] COM(2008) 109 final. Communication from the Commission to the Council and the European Parliament on measures to change the VAT system to fight fraud, Brussels 2008 p 7.

[77] COM(2008) 109 final. Communication from the Commission to the Council and the European Parliament on measures to change the VAT system to fight fraud, Brussels 2008 p 9.

[78] COM(2008) 109 final. Communication from the Commission to the Council and the European Parliament on measures to change the VAT system to fight fraud, Brussels 2008 p 10.

[79] Kogels, Han: *VAT Fraud with Emission Allowances Trading*, EC Tax Review 2010-5 p 187.

3.5 Summary

The possibility of trading with carbon emission allowances is very important for the EU's fulfillment of its Kyoto obligations. However, the obstacles of stopping VAT fraud are not easily solved. Before the EU Directive 2010/23/EU allowing the reverse charge as a temporary solution, Member States chose several different approaches to solve the problem. Other than the reverse charge, zero rating and exempting carbon emission allowances from VAT were methods used, to name a few.
The Unions reluctance of applying the reverse charge mechanism for EUA trade is evident, not only insofar the solution has only been made a temporary and voluntary one, but moreover, as the ECOFIN investigation into the matter shows, it is too great a change of the entire VA system. Reverse charge is fundamentally different from the approach to VAT used in the RVD, hence the unwillingness of using it, even if only temporary. This was most definitely the reason for time limit on the abovementioned Directive on the matter. It may also have been the reason why the Union did not implement it quicker, but was hoping to solve the issue in a more convenient way from the beginning. Obviously, no simple solution exists. There are however, other possible means to solve the problem with VAT fraud on EUA's. Some of these will be investigated hereafter.

4 Stopping the Carousel

There are, naturally, ample of thoughts on how the issue of VAT fraud should be dealt with. This chapter will not be an exhaustive recapitulation of all the ideas on the subject, but a more focused investigation into the most prominent and suitable solutions chosen at the author's discretion.

4.1 The Quick Reaction Mechanism

The currently available means to combat VAT fraud are insufficient for Member States. The possibility to temporarily employ a reverse charge mechanism, as discussed above, is only applicable on carbon emission rights for example. Consequently, VAT fraud with any other goods is unstoppable through that Directive.

Article 395 RVD offers a possibility for Member States to derogate from the RVD in a certain aspect in order to combat fraud. However, the procedures of attaining the right to derogate are complex. A right to derogate "requires a (positive) proposal from the Commission, a process which can take up to 8 months […] and unanimous adoption by the Council, which can lead to further delays"[80] according to the European Commission.

Not only is this process very slow, but a Member State also runs the risk of waiting for the bureaucracy for almost a year, only to have the Commission propose the application should not be authorised or the Council unable to reach a unanimous decision.[81]

Evidently this is not a satisfactory situation for either party. This is why the European Commission proposed that Article 395 RVD be supplemented with a quick reaction mechanism (QRM), adding Articles *395a* and *395b*.[82]

[80] COM(2012) 428 Final. Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards a quick reaction mechanism against VAT fraud, 1. Context of the Proposal, p 2.

[81] Lejeune, Ine and Others: *Quick Reaction Mechanism against EU VAT Fraud*, International VAT Monitor March/April 2013 p 95.

[82] COM(2012) 428 Final. Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards a quick reaction mechanism against VAT fraud.

Essentially the new articles, implementing the QRM, will speed up the Members States actions against fraud. Within a month the Commission must authorise or inform the Member State why it objects to the application.[83]
There are certain limitations to the QRM. It is only meant to “combat sudden and massive forms of tax fraud in the field of VAT which could lead to considerable and irreparable financial losses”.[84] Furthermore any such acts will be in force for no more than one year.[85]
In sum, the QRM seems to be a temporary solution for Member States in order to use the possibility of derogation found in the old Article 395 RVD without the bureaucracy being an issue. After a Member State has applied for a temporary derogation under the QRM, it can afford to wait for up till ten months for a decision on the derogation in Article 395 RVD without the wait causing further harm through ongoing VAT carousels.
In that sense, the quick reaction mechanism is not really a solution to anything, but just an extension of the red tape.

4.2 Structural Change of the VAT System

One possible way of solving the issue of VAT fraud is to change the very structure of the current VAT system. There are different ideas on what should be changed in order to stop the possibilities of fraud. One has to bear in mind however, the effect a substantial change of the VAT structure might have. Additional compliance and costs of compliance for companies are unwanted. Furthermore, reaching a political consensus on a change of the fundamental parts of VAT would not be easy.
Regardless, some of the more proposed structural changes of the VAT system believed to solve the MTIC will be evaluated in this chapter.

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[83] Lejeune, Ine and Others: *Quick Reaction Mechanism against EU VAT Fraud*, International VAT Monitor March/April 2013 p 96.
[84] Article 395(a) COM(2012) 428 Final. Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards a quick reaction mechanism against VAT fraud. Brussels 2012.
[85] Article 395(a) COM(2012) 428 Final. Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards a quick reaction mechanism against VAT fraud. Brussels 2012.

4.2.1 The Reverse Charge Mechanism

One way of dealing with the VAT fraud would be to apply a reverse charge on all business-to-business (B2B) trades. Just as is the case on imported goods, the reverse charge shifts the VAT liability from the seller to the buyer.[86] A regular MTIC would not work under the reverse charge mechanism (RCM); the missing trader could not disappear with any undue VAT, but only without paying his own VAT debt.[87]

Germany and Austria proposed a RCM for all B2B transactions in order to prevent VAT fraud.[88] Back in 2006, Germany even applied for the right to derogate from the RVD and implement the RCM in respect of all B2B transactions in excess of €5000.[89] Similarly Austria applied for the right to use the RCM on all B2B supplies of goods and services where the invoice exceeded €10 000.[90]

Nonetheless the Commission would not allow Germany and Austria to diverge from the RVD in such a way, for a number of reasons. Firstly, such a change would be fundamental to the VAT system, eliminating fractioned payment more or less completely in these two countries. Furthermore it would be burdensome for taxable persons insofar they would have three different tax systems to abide by; the regular VAT system, the intra-community system and lastly the proposed RCM for B2B transactions.[91] Lastly, the RCM is no guarantee to stop fraud. If it is only implemented on some of the goods most targeted by VAT fraud, the goods used for fraud is likely to just change. Moreover fraud is possible within the RCM system; since the system removes part of the companies' liability for outgoing VAT,

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[86] Keen, Michael. – Smith, Stephen: *VAT Fraud and Evasion: What Do We Know and What Can Be Done?* National Tax Journal Vol. LIX, No. 4 December 2006 p 880.
[87] Keen, Michael. – Smith, Stephen: *VAT Fraud and Evasion: What Do We Know and What Can Be Done?* National Tax Journal Vol. LIX, No. 4 December 2006 p 880.
[88] COM(2006) 404 Final. Communication from the Commission to the Council in accordance with Art. 27(3) of Directive 77/388/EEC. Brussels 2006 p 2.
[89] COM(2006) 404 Final. Communication from the Commission to the Council in accordance with Art. 27(3) of Directive 77/388/EEC. Brussels 2006 p 3.
[90] COM(2006) 404 Final. Communication from the Commission to the Council in accordance with Art. 27(3) of Directive 77/388/EEC. Brussels 2006 p 2.
[91] COM(2006) 404 Final. Communication from the Commission to the Council in accordance with Art. 27(3) of Directive 77/388/EEC. Brussels 2006 p 6.

it will most likely increase the refund claims.[92] This is very difficult to control for the authorities and it is likely to lead to fraud in terms of excessive claims.[93]

All things considered, the EU is reluctant to any use of the RCM as it is such a fundamentally different approach to VAT collecting as compared to the current system. Additionally, it is not a guaranteed solution, but could very well serve only to shift VAT fraud from one kind to another whilst simultaneously changing and increasing the administrative burden both for private traders and the tax authorities. Likewise, using the reversed charge to stop VAT fraud in a specific sector, such as carbon emission trading, is very much like treating the symptoms of VAT fraud and not the disease. The EU will want to find a way to solve the whole of VAT fraud, not moving the problem from sector to sector with insufficient temporary amendments to the regulations.

4.2.2 The Flat Rate Origin System

Proposed by the European Commission in 2008, the flat rate origin system is another structural change of the VAT system believed to be able to stop the carousel fraud within the Union.[94]

Essentially, the flat rate origin system will make all intra-community acquisitions subject of a standardised flat rate VAT; the exemption on intra-community acquisitions would be substituted with a 15% flat rate VAT.[95] Subsequently the purchaser will have to claim a refund from the authorities in the country of origin where the VAT was paid. Furthermore, the reversed charge mechanism will be applied on the difference between the flat rate 15% and the domestic VAT rate in the Member State of arrival. If, by for example zero rating or reduced rate, the goods should have a VAT rate

[92] Keen, Michael. – Smith, Stephen: *VAT Fraud and Evasion: What Do We Know and What Can Be Done?* National Tax Journal Vol. LIX, No. 4 December 2006 p 880.
[93] Keen, Michael. – Smith, Stephen: *VAT Fraud and Evasion: What Do We Know and What Can Be Done?* National Tax Journal Vol. LIX, No. 4 December 2006 p 880.
[94] COM(2008) 109 Final. Communication from the Commission to the Council and the European Parliament on measures to change the VAT system to fight fraud, Brussels 2008.
[95] COM(2008) 109 Final. Communication from the Commission to the Council and the European Parliament on measures to change the VAT system to fight fraud, Brussels 2008 p 5.

below 15%, a credit will be given to the company purchasing.[96] A clearing house will be necessary in order to transfer VAT revenues between Member States.

Advantages of this system include an unaffected cost of compliance, since the seller would charge 15% instead of 0% and the complications of harmonising the VAT rates are rendered moot.[97]

Irrespective of this, the flat rate origin system does not fix what is broken, but only mends it in a way to decrease the harm. The possibility to fraud is not removed; the scope of the fraud is only decreased to the difference between 15% and the domestic VAT rate in the country of arrival.[98] Thus this system would serve to reduce the profitability, ergo the incentive, to use carousel fraud.

This is definitely a step in the right direction, yet in essence it is much ado about nothing. Drawing a parallel to the fraud with emission rights previously discussed, it is clear that this would be of insignificant importance. When trades can be concluded so rapidly, it would most likely only increase the number of trades hence having little or no effect on the actual amounts lost to fraud. Lastly, as always when implementing a new system, there will be a considerable start-up cost for the Member States in order to get the new system in place.

4.2.3 Summary

In order to change the VAT system, a unanimous approval is needed from the Member States. Naturally, this makes it very complicated; irrespective there is a consensus that something has to be done, reaching an agreement on *what* is to be done and *how* is not as easy. Member States will not give up any of its tax basis; hence any suggested solution involving a possible

[96] COM(2008) 109 Final. Communication from the Commission to the Council and the European Parliament on measures to change the VAT system to fight fraud, Brussels 2008 p 5.

[97] Report from the European Union Committee ordered by the House of Lords, European Union – Twentieth Report of Session 2006-07, *Stopping the Carousel: Missing Trader Fraud*, 8 May 2007 p 28.

[98] Report from the European Union Committee ordered by the House of Lords, European Union – Twentieth Report of Session 2006-07, *Stopping the Carousel: Missing Trader Fraud*, 8 May 2007 p 28.

shift of tax basis is likely to be vetoed by the Member State losing out on tax income.
Moreover, there is reluctance towards complicating compliance and increasing the cost of compliance for businesses. Obviously, the same goes for any structural changes leading to an increased administrative burden for the Member States.
The most natural way to proceed is increased harmonisation of the internal market, creating a completely unified inner market and VAT system, without any differentiation between domestic and intra-community supplies of goods for VAT reasons. So, the structural change of the VAT system to be preferred is a full out harmonisation of the single market that is the EU. This would demand a single VAT rate throughout the Union. However, reaching an agreement on such a great change of the system, with the intrusion on the remaining tax sovereignty of the Member States on the VAT area, is of course a major challenge.
All in all, solving MTIC with a structural change of the VAT system is complicated, both with regards to finding an actual solution to the problem as well as reaching a unanimous decision among Member States on actually implementing a new structure. It is more probable the Member States choose to deal with VAT fraud in a different manner.

4.3 Technological Solutions

The use of technology by criminals as a means to hone MTIC was made evident by the uncovering of VAT fraud on the greenhouse emission rights market. Since the technology is to some extent a party of the problem, or at least a catalyst, there are also suggestions on how it can be used as part of the solution. Technology could possibly provide an answer to MTIC without creating an immense administrative burden or complex and expensive compliance changes. A couple of ideas on how technology can be used will be examined and discussed hereunder.

4.3.1 VAT Locator Number

The VAT locator number (VLN) is one of the proposed technologies. The VLN would employ a centralised computer system used by the government to track all transactions between traders, in order to prevent MTIC without the need for any fundamental changes to the current VAT system.[99] All businesses would have to have a secure VLN, which would be attach to each invoice.[100] If there is no valid VLN, deduction of input VAT would be denied.

Each invoice would have its own unique VLN; nonetheless, from a compliance perspective it is believed that the process would be completely automatic.[101] Thus once the system is in place it would not cause any noticeable inconvenience for traders from that perspective.

However, there are downsides to the VLN solution. Firstly, it demands the tax authority makes a risk assessment on each transaction before issuing the VLN, leading to a very arbitrary decision making.[102] Also, the point of the VLN is the possibility to trace individual goods by their unique number. Consequently, it might be too complex assort every good and maybe even the separate parts of every good with its own VLN; not to mention the problems arising for traders who keep goods in storage if all goods need to be paired up with a specific number.[103] Any goods stored in bulk would be practically impossible to divvy up on demand; hence a line would have to be drawn somewhere settling to what extent goods are to be in need of a separate VLN or not. If VLN is to be used, it would most certainly have to be applied only to specific, fraud laden sectors. It would most likely be effective in stopping fraud in those sectors, but the risk of fraud shifting to unprotected goods instead is overwhelming.

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[99] Ainsworth, Richard T: *Technology Can Solve MTIC Fraud – VLN, RTvat, D-VAT certification*, International VAT Monitor, May/June 2011 p 155.
[100] Ainsworth, Richard T: *Technology Can Solve MTIC Fraud – VLN, RTvat, D-VAT certification*, International VAT Monitor, May/June 2011 p 155.
[101] Ainsworth, Richard T: *Technology Can Solve MTIC Fraud – VLN, RTvat, D-VAT certification*, International VAT Monitor, May/June 2011 p 155.
[102] Ainsworth, Richard T: *Technology Can Solve MTIC Fraud – VLN, RTvat, D-VAT certification*, International VAT Monitor, May/June 2011 p 156.
[103] Ainsworth, Richard T: *Technology Can Solve MTIC Fraud – VLN, RTvat, D-VAT certification*, International VAT Monitor, May/June 2011 p 156.

4.3.2 Real-time VAT Collection

The real-time VAT collection (RTvat) is, as the name implies, a shift of the VAT collection into real-time. The payment of VAT, as well as the right to deduct VAT, would be realised at the same time the transaction is paid for.[104] When the actual payment is made, a technological solution would split off the VAT from the price paid and divert it directly to the tax authority; thereafter the tax authority transfers the deductable amount back to the bank account of the customer right away.[105]

This would be a highly automated system and moreover, the companies would never be in possession of any VAT they could steal. MTIC would in that sense is stopped. RTvat would be an origin based system for VAT, but could just as well work in a destination based system.[106] Lastly, from compliance perspective it would not create any additional burden for companies since it would all run automatically. Please see *Supplement B* for two excellent depictions of how the RTvat would work under the origin and destination principle, borrowed from Richard T Ainsworth's article *Technology Can Solve MTIC Fraud*.[107]

Nonetheless, all transactions have to be made electronically for the RTvat system to work; cash payments are of course outside the scope of an electronically handled division of the VAT part of the payment.[108] This is not so much a problem for the B2B supplies as it is for the Business to Consumer (B2C) transactions. Most B2B transactions are made electronically anyway; leaving little or no change for the companies should this be implemented. For B2C on the other hand, cash payment is much more common and an abolishment of cash money is not very likely. It is plausible the RTvat system could be implemented only for B2B

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[104] Wohlfahrt, Beate: *The Future of the European VAT System*, International VAT Monitor November/December 2011 p 394.
[105] Wohlfahrt, Beate: *The Future of the European VAT System*, International VAT Monitor November/December 2011 p 394.
[106] Ainsworth, Richard T: *Technology Can Solve MTIC Fraud – VLN, RTvat, D-VAT certification*, International VAT Monitor, May/June 2011 p 156.
[107] Ainsworth, Richard T: *Technology Can Solve MTIC Fraud – VLN, RTvat, D-VAT certification*, International VAT Monitor, May/June 2011 p 157-158.
[108] Wohlfahrt, Beate: *The Future of the European VAT System*, International VAT Monitor November/December 2011 p 394.

transactions. It would mean some disruption in the system as far as the last step of the transaction chain, the B2C, is concerned, however it would be effective insofar as to stop the MTIC which occurs on the B2B stage of the transaction chain.

4.3.3 VAT Information Exchange System

Lastly, something has to be said on the VAT information exchange system (VIES). VIES is the only one of the discussed technological solutions actually in place already. However, it is not so much a solution as it is a means to exchange information in order to find and stop fraud. Its main function is the possibility for companies to instantly check the validity of a business partners VAT number.[109] Furthermore, the member states have access to information regarding trader’s name and address, where the VAT number is applicable and the dates of issue and expiration for the VAT number.

This is, naturally, a very helpful exchange of information, primarily beneficial for companies in letting them know if a VAT number of a business partner is valid or not. It does offer some protection in that sense, making businesses aware if a VAT number has been suspended or similar. That is, as long as businesses check the validity of their business partners’ VAT numbers on a regular basis. Most likely companies use the VIES before the first trade is commenced with a new business partner, whereon after it is assumed that the validity of the VAT number will not change. Furthermore, a valid VAT number does not necessarily make an honest trader. A VAT number can be hijacked or a carousel can be ongoing with a perfectly valid VAT number as long as the fraud is not uncovered.

To conclude, the VIES does fill an important function for companies, even if it is not a definitive proof of companies honesty. It was never meant to stop MTIC, but might still help stop or uncover carousel fraud. Irrespective it offers a good way of exchanging information across the union.

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[109] European Commission: *VIES (VAT Information Exchange System) Inquiries* <http://ec.europa.eu/taxation_customs/taxation/vat/traders/vat_number/> accessed 2013-06-03.

4.3.4 Summary

Technology offers cost efficient ways to deal with VAT fraud without any major increase in compliance for businesses. In a world that is evermore connected through technology, it is only natural technology can offer ways to stop the MTIC. There is of course always the balance of hindering fraud, yet not implementing a system that is too intrusive, too complex or too expensive.

Of the above discussed technological suggestions, the RTvat seems the most viable option. It is quick, effective and it sets a stop to MTIC as the companies never have possession of any undue VAT. The issue of electronic payments only is quickly solving itself, as society moves more and more towards an electronic-only acceptance of payment. The people most keen on preserving the anonymity of cash money is to a large extent made up of people with untaxed funds and criminals using cash to hide their illegal businesses.[110] There are also benefits for companies, including never having to be audited for VAT another company in the transaction chain has failed to account for, at the same time as the government saves massive amounts of money from fraud.[111]

Richard Ainsworth argues that one of the great benefits of RTvat is its focus on money; ergo much of the privacy will remain intact since all a bank and the tax authority need to know is how much VAT is on an invoice for the system to work.[112] Then again, there is always the issue of getting such a vast system as the proposed RTvat in place, with the cost and complications of setting it up as the main obstacles to surmount. However, with the potential benefits for the tax authorities and to some extent businesses, the RTvat might stand a chance.

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[110] Williams, Christ: *Technology Can Solve MTIC Fraud – 2*, International VAT Monitor July/August 2011 p 230.

[111] Williams, Christ: *Technology Can Solve MTIC Fraud – 2*, International VAT Monitor July/August 2011 p 230.

[112] Ainsworth, Richard T: *Technology Can Solve MTIC Fraud – 3 and Final*, International VAT Monitor July/August 2011 p 232.

5 Final Remarks

In this final chapter, I will summarise the answers to the questions set out as the purpose for this thesis.

First of all, what makes missing trader fraud possible and how is it conducted? The reason why it is possible to conduct VAT fraud is in essence the combination of a common VAT system, a common internal market but domestic collection of VAT within the EU. Intra-community acquisitions are zero-rated, but a subsequent domestic supply is not. Thus the self-checking mechanism of the VAT system fails as it is possible for a company to buy goods free of VAT from a seller in another Member State and sell them onwards domestically with VAT. The fraudulent company can then keep the VAT and disappear.[113] Since the missing trader never intends on reporting the VAT, the price plus VAT is his margin and he can sell the goods cheaper than he bought them. This opens up for the possibility of innocent traders partaking in a carousel, where the company purchasing from the missing trader sells the goods back to the original producer in the other Member State and the whole process is repeated. Schemes can naturally be made infinitely more intricate by adding buffer companies and trading over more Member States.

The reason why the emission trading scheme has been so severely affected by the MTIC belongs to a number of factors. To start with the emission rights have a high value and since VAT is calculated as a percentage of the value of the goods, it means more VAT to steal. Moreover, since the goods are intangible and traded on market exchanges a trade is completed very fast and without any need of transportation of goods. A carousel can potentially go around several times a day. Lastly, these emission rights are treated just as any other goods for intra-community VAT as a main rule, even if the EU has adopted the possibility of the reversed charge as the Member States' prerogative.

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[113] See *Supplement 1*.

The European Court of Justice has dealt with a number of cases both directly and indirectly connected to VAT fraud. The most prominent ones have been concerned not with the party guilty of VAT fraud, but the counterpart. This is natural since the one guilty of fraud is often not caught and when caught there is usually no need for the case to go all the way to the ECJ. When the guilty party cannot be tracked down however, the Member States have shown a keen interest in trying to hold anyone who has traded with the missing trader as responsible for the missing VAT in what is called joint and several liability. The main role of the ECJ case law with respect to stopping VAT fraud is the development of a far reaching protection of innocent parties, diminishing the Member States possibilities to hold innocent parties liable for lost VAT. This is mainly upheld through the notion that every transaction in a chain is regarded individually and stressing the importance and power of fundamental legal principles. Furthermore the ECJ has given great value to good faith and ruled out attempts from Member States to force companies into an investigation of their business partners' legitimacy. In essence the ECJ case law has forced Member States away from both the idea of joint and several liability as a solution to VAT fraud as well as the possibility of complex compliance rules for companies as an answer. This more or less forces the search for a solution away from domestic legislation and onto an EU level.

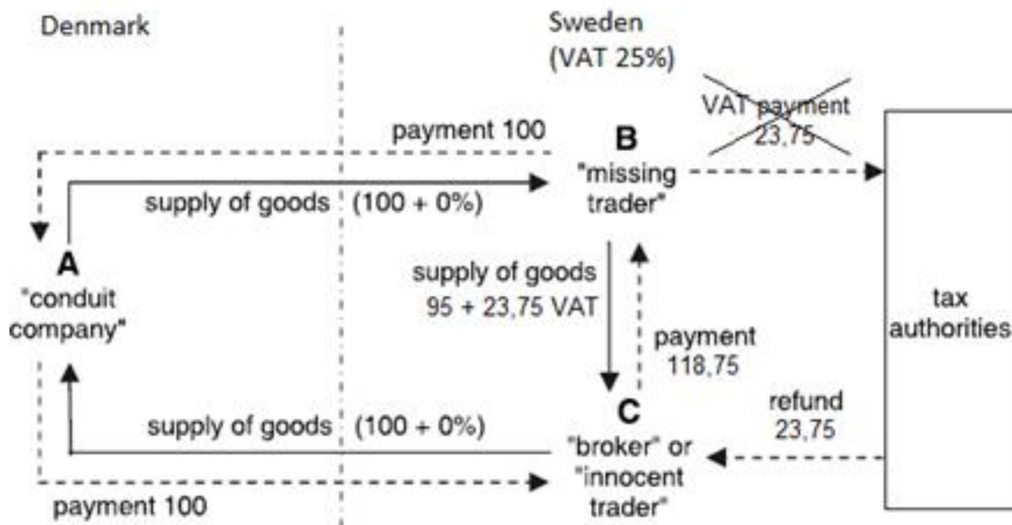
Indeed there is an ongoing search for a solution to the VAT fraud problem on an EU level; both legislative and technological ideas are evaluated. Personally, I believe a complete harmonisation of the inner market is the most sustainable solution to the VAT fraud at hand. If all trades within the EU were treated the same way as regular domestic trades are today, without any special schemes for zero-rated intra-community acquisitions and similar, the scope of fraud would be eradicated. The inner boarders kept between Member States, whilst simultaneously attempting a common inner market, is the only reason carousel fraud exists within the EU in the first place. Moreover, looking at the development of the EU up until this point, a completely harmonised market is the long term goal. The problem of course being the long term; even if the EU comes to a complete harmonisation in

the future it is obvious it will not happen overnight. Hence another solution is needed nonetheless. This is where technology comes into play. I personally feel that the RTvat would be the best solution out of the options discussed above. Not only is it a fast way to collect VAT, but since it takes away the possession of VAT from the companies, it is a win-win solution insofar as companies are relieved of the VAT compliance issues and at the same time the tax authority gets immediate possession of the tax money. There are, naturally, some downsides, especially the obstacle of cash money in this case. The system only works with electronic transactions, causing the anonymity of consumers to be destroyed.

All in all, I would argue that the RTvat is the only viable solution available at the moment and until the EU has truly accomplished a unified internal market it would prove an excellent way of coming to terms with the MTIC. Regarding the anonymity issue, I cannot see why this would be impossible to solve with technology if people find that to be the one reason why the RTvat should not be implemented. Except for that one flaw, it is the only system which has the benefit of simplifying VAT not only for the tax authority, but also for the companies within the EU. Lastly, it is important to stress that RTvat would work without the need of legislative changes to the VAT system, meaning it would be both fast and relatively cheap to implement.

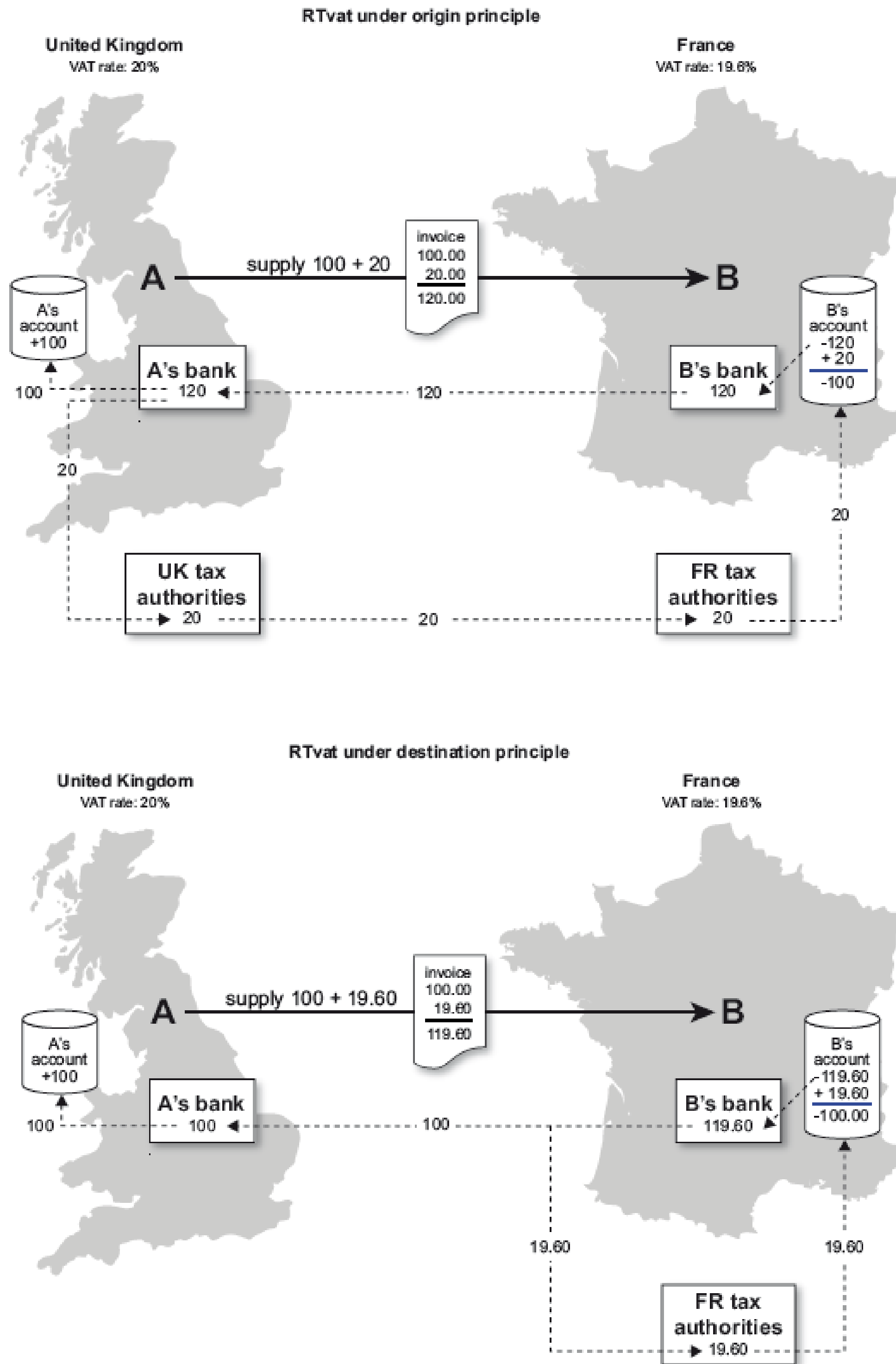
Supplement A

An example of a simple VAT carousel



Supplement B

RTvat under the origin and destination principle respectively.[114]



[114] Both figures are borrowed from Ainsworth, Richard T: *Technology Can Solve MTIC Fraud – VLN, RTvat, D-VAT certification*, International VAT Monitor, May/June 2011 p 157-158.

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