Stopping the Carousel: Missing Trader Fraud in the EU

Report with Evidence

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Oral Evidence

Mrs Sharon Bowles MEP
Oral evidence, 9 January 2007

Mr Rudy Volders, Director, and Mr Yannic Hulot, Fiscal Co-ordinator Research, Belgian Finance Ministry
Oral evidence, 10 January 2007

Commissioner Kovacs, Commissioner for Taxation and Customs Union, and Mr Stephen Bill, Head of Cabinet, European Commission
Written evidence
Oral evidence, 10 January 2007

Mr John Arnold and Mr Ian Hayes, Institute of Chartered Accountants in England and Wales, and Mr Chas Roy-Chowdhury, Association of Chartered Certified Accountants
Written evidence by Institute of Chartered Accountants in England and Wales
Written evidence by Association of Chartered Certified Accountants
Oral evidence, 30 January 2007
Supplementary written evidence by Institute of Chartered Accountants in England and Wales

Rt Hon Dawn Primarolo MP, Paymaster General, HM Treasury,
Mr Mike Eland, HM Revenue & Customs, and Mr Richard Brown, HM Treasury
Written evidence
Supplementary written evidence
Oral evidence, 6 February 2007
Supplementary letter by Rt Hon Dawn Primarolo MP
Further supplementary letter by Rt Hon Dawn Primarolo MP

Mr Royston Ford, Cunningham Lindsey Marine
Written evidence
Oral evidence, 27 February 2007

Ms Angela O’Hara, Vodafone, Mr Fred Howarth, Federation of Technological Industries, and Dr Michael Cheetham, Bond House Ltd
Written evidence by Federation of Technological Industries
Written evidence by Dr Michael Cheetham
Oral evidence, 27 February 2007

Mr Mike Eland and Mr Tony Walker, HM Revenue & Customs, and Mr Richard Brown, HM Treasury
Oral evidence, 17 April 2007

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Charities’ Tax Reform Group
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NOTE: References in the text of the report are as follows:
(Q) refers to a question in oral evidence
(p) refers to a page of written evidence
Cross-border transactions within the EU have, since 1992, been zero-rated for Value Added Tax (VAT). Importers of goods are thus able to receive goods without paying VAT, but charge VAT on their resale. If the VAT they receive is not then remitted to the revenue authority, they are committing a crime: this is Missing Trader Fraud. Should the goods be repeatedly exported and re-imported then this criminal practice can be repeated, giving the activity its more common name, Carousel Fraud.

This is not a fraud against the institutions of the European Union, nor does it occur because of any mismanagement by them. Instead it is the fiscal authorities of the Member States that are being defrauded, due to the rules that they have chosen to implement for the taxation of intra-Community trade. The report examines whether Missing Trader Fraud can ever be prevented under the current system and considers some alternative mechanisms for the taxation of intra-Community trade.

Attempts to undertake this fraud have risen considerably in the past decade, largely due to the proliferation of high value & low weight goods, such as mobile phones, and substantial losses—up to £4.75 billion for 2005/06—are estimated to have occurred in the UK alone. This report examines the measures that have been taken in the UK both to recoup income already obtained fraudulently by those undertaking this activity, and also to prevent the fraud from being able to occur. We look ahead to the limited reverse charge accounting system which is to be introduced to the sectors most commonly used by the criminals exploiting the loophole in the tax system.

In addition to considering the effectiveness of measures taken to date, we have also examined whether the Government’s policies to date have imposed an unreasonable burden upon legitimate businesses within the affected sectors.

We conclude that existing measures to tackle Missing Trader Fraud do not prevent its occurrence and are unsustainable. Furthermore, the Government needs to take real and substantive steps to ensure that their actions do not damage innocent traders. We accept that the reverse charge will eradicate Missing Trader Fraud from the sectors currently affected but we expect that the fraud will mutate to other sectors. We call on the Government to work with other Member States to implement a system for taxation of intra-Community transactions which will be more enduring and less vulnerable to major fraud.
CHAPTER 1: THE DEVELOPMENT OF MISSING TRADER INTRA-COMMUNITY FRAUD

Introduction

1. Missing Trader Intra-Community (MTIC) Fraud is an exceptional crime. It is exceptional in its scope: HM Revenue & Customs (HMRC) believe approximately £3 billion was retained by fraudsters in the 2005/06 financial year. It is exceptional in its execution: a deliberate criminal act undertaken by criminal gangs whose activities have lead to a distortion of the UK’s trade figures. It is also exceptional in its design: because of the nature of the VAT system companies are able to collect tax on behalf of the government and simply fail to remit it to HMRC. It is a high profile, lucrative and systemic fraud, but one which requires a solution which will neither propel the problem into other Member States nor place an over-onerous burden on legitimate business.

2. Our concern about MTIC fraud is heightened by the fact that it occurs because of a fundamental flaw in the design of the VAT system. This is not the plain evasion and fraud—such as under-reporting or mis-reporting of sales, or failing to register with the tax authority—that is also seen in other tax regimes. There is no evidence that the VAT evasion rate is higher than that for other forms of taxation: approximately 12% of the hypothetical VAT revenue is being lost each year, but a third of this loss is attributable to MTIC fraud.

VAT

3. Value Added Tax (VAT) has a key strength: the government effectively collects a proportion of the tax at each stage in the sales chain, rather than concentrating the potential revenue, and the risk of evasion, in the final seller. This “fractionated” nature is also VAT’s principal weakness: many more transactions have to be logged and reported by traders, raising both the regulatory burden and the difficulty of monitoring compliance. In addition, the seller of an item is collecting the tax on behalf of the revenue authority, rather than the revenue authority collecting it directly from the taxpayer. This extra link in the chain increases the opportunity for fraud. A tax authority considering claims for VAT repayment has to maintain a balance between not being so restrictive that legitimate claims are denied and the tax
effectively becomes a tax on production inputs, and not being so lax that fraud continues unchecked.

4. In the past forty years, VAT has been introduced in around 130 countries, including all OECD members other than the United States. Several European nations, including Denmark, France, Germany, the Netherlands and Sweden introduced the tax in the 1960s; the UK introduced VAT in 1973. The Council of Ministers adopted its First and Second VAT Directives\(^3\) in 1967, which introduced a common VAT system across Europe. The Sixth VAT Directive\(^4\), adopted in 1977, standardised the basis of the application of VAT on goods and services within the EU. The Sixth Directive has been amended and was replaced in 2006 by a recast text (the “Principal Directive”).\(^5\) Member States continue to operate derogations to allow them to apply a reduced rate or exempt classes of goods from VAT.

5. The abolition of barriers to internal trade in 1992 required further changes to the system of VAT applied to intra-Community trade. The Commission proposed a clearing house which would ensure that tax collected in the supplying Member State and deducted in the importing Member State would be passed to the latter Member State’s revenue authority. This proposal was rejected by the Council of Ministers, who expressed concerns that the clearing house would not be practicable, not least because Member States would have no incentive to investigate their purchasers in order to collect tax which would be passed on to another Member State.

6. Instead, Member States adopted a system under which intra-Community transactions were zero-rated. An exporter would not charge VAT, but would be able to claim a refund of input VAT; a purchaser would not pay VAT, but would have to charge it on subsequent sales and remit the VAT income to its fiscal authority. Thus consumption is taxed in the importing country. Any changes to this system, and other fiscal matters, require unanimity. This, along with a lack of political will to make a major change, has led to the current system continuing largely unchanged, despite suggestions on its introduction that it would only operate until 1997.

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\(^3\) 67/227/EEC and 67/228/EEC

\(^4\) 77/388/EEC

\(^5\) 2006/112/EC
FIGURE 1
A Basic MTIC Fraud

Company A
Purchases goods: either from Company D (completing the carousel) or new goods with which to start a carousel.
Exports goods to Company B in another Member State. Export sale is VAT zero-rated.

Company B: The Missing Trader
Purchases goods from Company A in Member State 2. Pays no VAT on purchase, because export by A is zero-rated.
Charges and receives VAT on sale to Company C.
Disappears without remitting the VAT to the revenue authorities.

Company C
‘Buffer’
Buys goods from B at VAT-inclusive price, and sells to D, charging VAT. C may be wholly unaware of the fraud.
(There may be multiple buffer companies between B and D, some or all of which may be honest.)

Company D
Pays VAT on purchase from Company C.
Exports goods to Company A, and receives a refund of VAT from the revenue authority on exported goods.
In effect reclaims the VAT not paid by B, and crystallises the revenue authority’s loss.

Member State 1

Member State 2

New goods join carousel

Adapted from VAT fraud and evasion: what do we know and what can be done? Keen & Smith, National Tax Journal Vol LIX, No 4 December 2006
7. In MTIC fraud’s most simple form, a trader collects tax on sales and then fails to remit it to the government, for example by engineering bankruptcy. In the past decade a more damaging form of this fraud has arisen in the European Union. It is not a fraud against the Community itself, and does not come about because of mismanagement by European institutions, but instead is an attack upon the measures Member States have introduced to promote cross-border trade in the Community. Growth in the fraud is driven by four factors:

(a) The increase in high value/low weight goods which make it easy and inexpensive to transport valuable consignments.

(b) The zero rate of taxation on intra-Community cross-border trade, which allows purchasers of goods from other EU countries not to pay VAT on purchase, although they then charge VAT on sales as normal.

(c) At the same time, exporters of goods are still able to reclaim VAT they have paid to other traders, thus crystallising the loss as the revenue authority refunds a payment for which it had not received a remittance earlier in the transaction chain.

(d) The abolition of frontier formalities within the European Community which prevents Member States from operating procedures which could impede the free flow of goods within the Union. This means that the verification of the zero-rated goods imported could only be based on an audit of the traders’ transaction records—a process which at present is normally only undertaken when VAT receipts are remitted, some time after the transactions.

8. In MTIC fraud’s more virulent form, the first and fourth factors above are abused to trade repeatedly the same consignment of goods between companies set up for this specific purpose. It is this repeated cycling of goods which gives this version of the fraud its common name of Carousel Fraud.

9. Once the shell companies have been created, MTIC fraud is a relatively simple crime to commit, with the cycling of goods allowing continuing profit from one initial outlay. While it is more lucrative on zero-rated intra-Community trade, it can also occur on trade from countries outside of the EU. In these cases, illustrated in figure two, goods enter the EU in one Member State with a final destination in a different Member State, and under the Community Transit rules they travel duty-free within the Union. Before reaching their supposed final destination, goods are diverted to smaller consignments and their true source masked. The Common Customs Tariff remains unpaid on these items.

It is also suggested that in many cases of the fraud, the goods do not exist, or are only traded on paper (p 30).
FIGURE 2
An MTIC fraud including extra-Community trade

Member State 1

Company 1
A Broker at the end of the chain exports to a third country outside the European Union and is entitled to repayment of input VAT from the revenue authority. Fraudsters typically export to third countries with low duties on imports or free trade zones.

Country outside the European Union

Purchases goods from Broker and exports to the European Union with final destination stated as Member State 1. On entering the European Union in Member State 2, import duties are deferred under Community Transit rules until goods reach the final country of destination.

Chain of traders (Missing Trader and "buffers") within a member State operate a Basic Carousel Fraud (see Figure 1).

Member State 2

Consignments are split and sold through a number of traders in different Member States to mask the true identity of the goods.

Member State 3

Company 4
Goods emerge as intra-community supplies, which are sold free of VAT to an importer in Member State 1.

10. We were told that cargo planes are chartered each week to carry electronic goods out of the EU as part of the extended carousel fraud outlined in Figure 2 (Q 277). This type of fraud is able to occur because of poor management and oversight of the Community Transit system by Member States.

11. The European Court of Auditors recently reported on the Community Transit system and found:

“Commission services have not yet carried out analyses of transit fraud patterns nor developed transit-specific risk analysis tools. Systematic risk management for transit is rudimentary or non-existent in many Member States and only a few of them have risk profiles integrated into NCTS [New Computerised Transit System]. The number of physical checks on transit consignments is very low in some Member States, and in some they are non-existent.”

12. The Court of Auditors’ Report makes several recommendations for improvement and the Commission is considering these. The Paymaster General has told us that the Government will support these improvements when they are brought forward, and we recommend that Government works with other Member States to ensure that these changes are prioritised in order to attack the supply chain for this variant of MTIC Fraud.

Losses to MTIC Fraud

13. MTIC fraud occurs across the EU. Very few Member States publish estimates of the size of the problem but the European Commission believes that in some countries it has reached levels of up to 10% of VAT receipts. Germany has recognised that the fraud is a significant problem; it estimated a reduction in revenues due to MTIC frauds of €4.5 billion in 2002. The National Audit Office reported that Denmark and the Netherlands were often used by fraudsters as the location for apparently legitimate transactions in a larger chain in which the tax is being stolen in other Member States, such as the UK.

14. In the UK, levels of MTIC fraud have risen since it was first identified and measured in the late 1990s. However, like any criminal activity its nature makes it difficult to measure, and we have been presented with a variety of different estimates of the size of the activity. HMRC’s estimates of the size of MTIC fraud are contained in Table 1:

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9 European Court of Auditors Special Report No 11/2006 on the Community transit system OJ C44 (27 February 2007) p 1
10 The improvements include: improving the management and operation of the NCTS within Member States; taking steps to encourage closer work between Member States using the NCTS; proposing sanctions against traders who block enquiries; requiring Member States to take prompter action to recover unpaid duties; improving the levels of risk management within Member States Customs’ authorities, and requiring the Member States to carry out more physical checks on consignments.
11 Government Explanatory Memorandum 7073/07, 15 March 2007
TABLE 1

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<thead>
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<th>Year</th>
<th>Estimated size of MTIC fraud—HMRC</th>
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<tr>
<td>1999/2000</td>
<td>£1.5–£2.4bn</td>
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<tr>
<td>2000/1</td>
<td>£1.3–£2.5bn</td>
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<tr>
<td>2001/2</td>
<td>£1.7–£2.5bn</td>
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<td>2002/3</td>
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<tr>
<td>2003/4</td>
<td>£1.1–£1.7bn</td>
</tr>
<tr>
<td>2004/5</td>
<td>£1.1–£1.9bn</td>
</tr>
<tr>
<td>2005/616</td>
<td>£3.5–£4.75bn</td>
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15. HMRC produced two figures for 2005/6. One used the existing methodology and produced an estimate of the size of the fraud of £1.4–£2.4 billion, but this figure was not supported by operational indicators. Operational evidence instead suggests that the scale of attempted fraud in 2005/06 is £3.5–£4.75 billion. It is possible that the scale of the fraud in earlier years may also have been higher than estimated. The Paymaster General told us that she is confident that the size of the fraud recorded in 2006/07 will be lower than in previous years (Q 237).

16. Separate figures produced by the “Eurocanet” project17 have been widely quoted in media coverage of MTIC fraud and were referred to by some witnesses. Their report18 suggests that the UK lost £8.4 billion to the fraud in the year to June 2006. We do not agree with their analysis, which was based on inadequate information and did not justify the conclusions drawn. We believe HMRC’s calculations are more realistic.

17. The majority of the frauds in recent years have centred on the mobile phone and computer chip sectors, although the subject of the fraud is beginning to diversify. Witnesses told us that cosmetics, “precious” metals and computer software were products that criminals were now targeting (Q 273, pp 70–1) and the Paymaster General also outlined a range of goods that were potential vehicles for fraud (p 66). The industries used by the criminals generally involve high value/low weight goods, or service industries, usually with few barriers to entry. Industries with a significant grey market are common targets.

15 Source for 2000/1–2005/6: HMRC supplementary evidence Annex D 27 February (p 63). The figure for 1999/2000 is a measurement of the estimated loss to HMRC due to the fraud, rather than the level of the fraud itself. Source: Measuring Indirect Tax Losses November 2002 HM Customs and Excise

16 HMRC introduced a new methodology for calculating the loss to the fraud in 2005/6. Source for this row: Measuring Indirect Tax Losses December 2006 HM Revenue & Customs

17 A programme of mutual assistance between Member States’ Fiscal and Law Enforcement authorities. Led by the Belgian VAT carousel support unit, it aimed to identify Missing Traders by compiling information on fraudulent transactions (Q 53). However, the information it was able to use was restricted by some Member States, who raised concerns about sharing information relating to criminal investigations.

18 An English translation of extracts from their report, Tentative d’évaluation de la Fraude à la TVA transfrontalière, is reproduced in the evidence (pp 126–132)
BOX 1
Grey Market

A “grey market” normally refers to the flow of new goods through distribution channels other than those usually authorised or intended by the manufacturer. Goods are imported outside of the manufacturer’s normal distribution channels, often in order to take advantage of different pricing policies in different jurisdictions, and normally sold on at a price below the manufacturer’s recommended level. Some grey markets include goods traded entirely legitimately, for example when a manufacturer is looking to dispose of excess stock.

18. It is clear from the evidence we have received that a number of participants—often small businesses operating in the grey market—in the mobile telephone and computer chip sectors have been adversely affected by the Government’s attempts to eradicate the fraud in their industry. Big businesses do not appear to have been affected, primarily because they trade directly with manufacturers and end users (Q 286).

19. **Missing Trader Intra-Community Fraud** is occurring on a substantial scale across the European Union. We agree with HMRC that this is an outright attack on the tax system (Q 224), and note that it precipitates other crimes, such as theft of consignments (p 68). We accept the evidence that the majority of the fraud is being undertaken by a small number of sophisticated criminal gangs (QQ 275–276, 341–344).

**A need for further action?**

20. In this report we consider the actions already taken by the Government to tackle MTIC fraud, including the planned introduction of a “reverse charge” mechanism for VAT in the mobile telephone and computer chip sectors from June 2007. We also examine whether further action will be necessary, either in the form of changes to administrative practice in the UK, or via a major change to the European VAT system which would require unanimous agreement of EU Member States. For each possible change, we will consider two tests: whether it would stop the fraud; and whether it appears that it would create insurmountable compliance costs for legitimate business.

21. We make this report for debate.
CHAPTER 2: TACKLING MTIC FRAUD: ACTIONS TO DATE

Extended Verification and Joint & Several Liability

22. The Paymaster General outlined HMRC’s strategy to date for interrupting MTIC fraud in her written evidence (pp 47–8) and oral evidence (QQ 229, 232–236). Over 1500 HMRC staff are now employed on the MTIC strategy, at a cost of £95 million per year (p 66). The strategy dates back to September 2000 but has evolved over time. It started by using risk-based controls to identify, prevent and disrupt potentially bogus businesses and transactions. HMRC initially argued that purchases and sales in the supply chain were not part of any economic activity for VAT purposes and thus fell outside the scope of VAT. This meant that VAT purportedly paid to suppliers was not VAT which could be reclaimed. HMRC attempted to recoup the VAT charged, but never paid over by the missing trader, by refusing to repay the VAT reclaimed later in the supply chain, typically by the exporter of the goods. This approach was challenged by those denied refunds in the UK courts and ultimately the European Court of Justice (ECJ), in Bond House: the Court ruled against HMRC’s approach.

23. The ECJ held that the transactions in question were supplies of goods or services for the purposes of the then Sixth Directive: as long as a transaction itself was not vitiated by VAT fraud, the right to deduct VAT paid could not be affected by the fact that there was a fraud elsewhere in the supply chain. However, the right to reclaim VAT was taken away where the trader knew or had any means of knowing that there was fraud within the supply chain. This judgment was released in January 2006 and, according to HMRC, is the reason for the very significant rise in carousel fraud in the early part of 2006, presumably because the fraudsters felt encouraged that VAT recovery could not be denied on “non-economic activity” grounds.

24. HMRC’s position was clarified in July 2006, with the judgment of the ECJ in Axel Kittel. Following the decision in Bond House, the ECJ held that where it is ascertained, having regard to objective factors, that the trader knew or should have known that, by his purchase, he was participating in a transaction connected with VAT fraud, he can be refused his entitlement to the right to deduct VAT. However, the Court said that traders would not risk losing the right to deduct VAT paid where they “take every precaution which could reasonably be required of them to ensure that their transactions are not connected with fraud.”

25. As a result of these cases, HMRC’s approach in the past year has focused on a “means of knowledge” test involving extended verification; HMRC staff conduct 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. As HMRC explained, this is an extensive task as some chains involve over 600 companies (Q 321).

19 Cases C-354/03, C-355/03 and C-484/03. Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs & Excise [2006] ECR I-483.


21 Ibid. Paragraph 51
26. But firms who are confident that they have never traded directly with fraudulent participants claim to have had VAT repayments withheld (pp 76, 108–9, 135–6, QQ 289–290). The Federation of Technological Industries and others told us that every participant in the grey markets for mobile phones and computer chips has had their VAT repayments withheld since spring 2006, and that the due diligence required by firms under the “means of knowledge” test appears to be imposing an increasing burden on legitimate businesses (QQ 288–289). HMRC disputed this claim, although they did indicate that up to 1500 firms are currently subject to extended verification and that some of these firms may not have been a complicit party to the fraud (Q 336). HMRC also said that traders facing bankruptcy can receive repayments while verification is ongoing, if security for the repayment is given, and that they take steps regularly to inform firms subject to extended verification of progress (QQ 322–323).

27. HMRC’s interpretation of the scope of the “means of knowledge” test has been considered by the UK courts22 but its application is yet to be considered by the VAT and Duties Tribunal against the facts of a particular case. The Federation of Technological Industries told us that they planned to challenge the legality of HMRC’s approach in a judicial review (Q 308).

28. As things stand, HMRC has no option but to continue with extended verification; however they need to take real and substantive steps to ensure that their actions do not damage the innocent and are proportionate to the scale of the fraud. We note that, according to the Paymaster General, this approach has led to a “massive drop” in attempted MTIC fraud in 2006/07 (Q 231). This appears to justify their approach, however, the system of extended verification is an inefficient and unsustainable use of HMRC’s resources, and does impose a significant burden on smaller firms.

29. Under UK law, section 77A of the VAT Act 1994 entitles HMRC to issue a notice that persons in a supply chain may be joint and severally liable for VAT unpaid if HMRC has reasonable grounds to suspect that the VAT would go unpaid elsewhere in the supply chain. The provision only applies to certain goods23 and only when the addressee knew or had reasonable grounds to suspect that VAT would go unpaid on the supply to which it is a party or earlier in the supply chain.24 Although the sectors in which most of the MTIC fraud has occurred are already covered by the scope of section 77A, the powers have not been widely imposed by HMRC. Section 77A has been referred to, however, in warning letters issued by HMRC designed to deter companies from trading in a way which HMRC believes puts them at risk of becoming liable for unpaid VAT elsewhere in their transaction chains (Q 325).

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22 HMRC’s interpretation of the scope and application of the “means of knowledge” test has been considered in Dragon Futures Limited (Decision of the VAT & Duties Tribunal dated 10 October 2006) and Just Fabulous (UK) Ltd, Evolution Export Trading Ltd and Greystone Trading Ltd; Brayfal Ltd (Judgment of Mr Justice Burton dated 15 March 2007). The VAT and Duties Tribunal’s first hearing to consider the facts of a particular case (CallTel Telecom Ltd and Opto Telelinks (Europe) Ltd) was held in early May 2007.

23 Originally section 77A was limited to telephones, computers and their parts and accessories. The range of goods was extended by a Treasury Order of 21 March 2007 to include “certain sorts of electronic equipment, of a kind ordinarily owned by individuals and used by them for the purposes of leisure, amusement or entertainment”, and to clarify the inclusion of satellite navigation systems.

24 The 2007 Finance Bill includes provisions to extend the circumstances in which HMRC may presume the business had reasonable grounds to suspect fraudulent activity in the supply chain.
30. While the range of section 77A is limited to certain products, the ECJ rulings and the “means of knowledge” test can be applied to all exported goods. In practice the Government has already sought to extend the “joint and several liability” provisions to allow HMRC to apply these powers alongside the “means of knowledge” test.

**Disruption of criminal activity**

31. HMRC has also taken steps to disrupt the activities of fraudulent traders. HMRC believe that a relatively small number—in “the low end of the hundreds”—of sophisticated criminal gangs are behind the fraud, and it is likely that most of these gangs are also involved in other criminal activity including money-laundering and smuggling (QQ 342–344). The Paymaster General told us that “thousands of accounts” at an offshore bank had been frozen following HMRC’s investigations, and that accounts at other banks were being investigated (QQ 241–244). The Minister also stated that HMRC is working with the Serious and Organised Crime Agency and other police forces and were continuing to work towards prosecutions (Q 345). The Paymaster General has also visited Dubai to hold talks on fraud and recouping money from fraudsters’ accounts in the United Arab Emirates (Q 224).

32. The Metropolitan Police Service coordinates Operation Grafton, a multi-agency initiative tackling organised crime in the Heathrow area, where many freight forwarders are based. It is possible that some freight forwarders may be facilitating MTIC fraud if they act as a conduit for goods which are being repeatedly imported and exported. We were told that Customs have the power to log the contents of consignments of mobile telephones in order to trace goods moving into and out of the country; this works for these products, currently used in the fraud, but may not be a useful measure as the fraud mutates into products without serial numbers.

33. HMRC is content that they have the right range of powers to tackle the criminal groups undertaking the fraudulent activity. We welcome work between Customs and other law enforcement agencies to target the criminals behind the frauds, although in so doing we note that this close cooperation is only needed because the crime is so easy to accomplish.

**Cross-border co-operation**

34. While this work continues, HMRC’s strategy has broadened to include co-operation with other EU Member States. The European Commission operates the VAT Information Exchange System, which can be used by exporters to verify that their customer in another Member State is registered for VAT and thus entitled to a zero-rated purchase. We were told by Commissioner Kovacs that the system is significantly under-used. In 2005,

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25 In a joint operation with the authorities in the Netherlands, accounts at the First Curacao International Bank in the Dutch Antilles were frozen.

26 During 2005/06, there were six successful prosecutions resulting in 18 convictions with sentences totalling 72 years imprisonment. HMRC also took action against 29 companies involved in MTIC fraud resulting in £9.4 million being recovered or frozen (HMRC Annual Report 2005–06). Ongoing prosecutions involve some £2.5 billion of VAT (HL Written Answer 27 March 2007 col 266).

27 Mobile telephones have unique IMEI identification numbers which are relatively difficult to change. We were told that other goods have no identifying marks and can be repackaged (Q 273, p 70)
there were only 26,000 information exchanges, despite there being 35 million traders involved in intra-Community trade (Q 115). The Paymaster General told us that the November 2006 ECOFIN agreed there is a need for more rapid exchange of information and the UK is part of a working group looking at ways to improve the efficiency of the VAT Information Exchange System (p 64). Commissioner Kovacs also noted that the Commission has taken the first step towards developing proposals to clarify and strengthen the legal framework for operational assistance between countries (Q 115).  

35. There is an absolute need for revenue bodies to work with law enforcement agencies within each Member States, and across borders. HMRC have taken a lead on this work by hosting a conference for European law enforcement agencies and tax authorities in February 2007 (QQ 225–226), and we would welcome increased coordination of links between customs authorities and law enforcement agencies, rather than a series of bilateral links. This work must continue: the scale of this fraud demands cross-border co-operation between revenue authorities and law enforcement agencies. Concern about protection of data shared during joint work (Q 222) must be resolved.

36. As outlined in Figure 3, the reverse charge allows a VAT-registered firm selling goods to another VAT-registered firm not to charge VAT. The tax is only collected by a firm which is selling on the product to a final consumer or a non-VAT registered firm. Critics of the reverse charge have noted that this still creates the opportunity for a firm to become a missing trader, and suggest that the problem may be magnified: as tax has not been collected in stages along the consumption chain, all of the tax due on the product is concentrated in the last trader (pp 79, 108). On the other hand, there are fewer traders collecting the tax for the revenue authority to monitor. In addition, as VAT is not collected by any one trader in the chain depicted in Figure 1, there is no opportunity for trade carousels to develop.

37. While all of the measures described thus far create, in the Paymaster General’s words, “a severe downward pressure on the potential loss” (Q 248), they can only be a palliative and will not prevent the fraud from happening. In 2006 an application was made by the Government for a derogation to enable the introduction in the UK of a reverse charge accounting procedure for the goods most commonly used in MTIC frauds. Changes to the VAT system require the unanimous approval of the Council; after some negotiation with other Member States, who may have been concerned that the derogation would move fraud from the UK to their territories, the derogation was granted and the measure will come into force on 1 June 2007. The Paymaster General explained the reasons for the delay were of a technical nature, with other Member States seeking reassurance that the proposal would truly be limited (Q 257).

38. The limited reverse charge is not unprecedented. A “Special Accounting Scheme for Gold” was introduced in the UK in April 1993, and since January 2000, “investment” gold has not been subject to the standard VAT rules anywhere in the European Union. These measures were introduced to

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28 COM(2006) 254
29 HMRC have also participated in cross-border operations with colleagues overseas (Q 340).
30 This is an issue we have addressed in other reports, most recently in European Union Committee, 18th Report (2006–07): Prüm: an effective weapon against terrorism and crime? (HL 90)
31 OJ L109 (26 April 2007) p 42
combat VAT fraud being undertaken using investment gold, and also to protect the City of London’s requirements as a major trading centre of gold. The measures are now accepted and understood by participants in the gold markets.

Reverse Charge

FIGURE 3

A Reverse Charge accounting system

COMPANY A
Sells goods to Company B for £100. No VAT is charged. Submits to Revenue Authority Reverse Charge Sales List (RCSL) of customers to whom sales without VAT have been made.

COMPANY B
Reverse charges himself VAT on purchase price of £100, declaring £17.50 payable to revenue authority on the VAT return. Reclaims input VAT of £17.50 on the same VAT return. No net VAT is due. Sells to Company C for £150. No VAT is charged. Submits RCSL to revenue authority.

COMPANY C
Reverse charges himself VAT on purchase price of £150, declaring £26.25 payable to revenue authority on the VAT return. Reclaims input VAT of £26.25 on the same VAT return. Sells to final consumer for £200 plus £35 VAT. Output VAT of £35 declared on VAT return and paid to revenue authority.

Revenue Authority
Rather than receiving a proportion of the VAT due at each point in the supply chain (fractionated system), the authority receives the amount due of £35 in one sum from Company C, once the goods are sold to the final consumer.

39. For this change to the VAT system, HMRC have worked with the mobile telephone and computer chip industries to design the reverse charge in a way which minimises administrative costs (Q 311). HMRC are also educating industry about the changes to the accounting methods through a dedicated team of several hundred staff who work to educate the public of changes to the tax system (Q 315). We support their decision to apply a light touch to compliance activity in the first year of the charge, particularly as some witnesses have suggested that the transition time is not long enough (Q 311, pp 124, 238). We also support the decision to raise the de minimis level to £5000, as we received evidence noting the difficulties the proposed £1000 de minimis level would create for retailers and the charity sector (p 103).
40. HMRC states that they now have the monitoring capability to detect the growth of fraud in other sectors before it gets out of control (Q 334), but recording fraud via monitoring is not the same as preventing it from occurring. **It is generally accepted that the broad phenomenon of MTIC fraud is out of control; we expect it to continue to mutate into other sectors.** The reverse charge is only a temporary solution.
CHAPTER 3: FURTHER ADMINISTRATIVE ACTIONS

41. As well as the measures taken to date considered in chapter two, the evidence we received suggested further administrative solutions. In this chapter we address these.

Scrutiny of new VAT registrations

42. The Paymaster General told us that enhanced measures are in place to monitor applicants for a VAT registration, and that these are processed within a reasonable time period despite these checks (QQ 232–233). Representatives from trade suggested that this work could be extended, with newly registered firms closely supervised—including on-site visits and examination of business plans—until they have demonstrated that they are trading legitimately (Q 288). Security for VAT due could be requested from newly registered businesses in sectors where risk of fraud was considered to be high (Q 306).

Real-time logging of trades and verification of counterparties

43. Some witnesses suggested that HMRC should concentrate its resources on monitoring transactions in real-time (or near real-time), hopefully uncovering non-economic transactions as they occur (p 121, Q 192, 303–304). HMRC have calculated the cost of such monitoring at £1.3 billion (p 64)—an amount which they might recoup in less than a year at current levels of fraud. It is likely that there would be significant transition costs for business, although a reporting threshold could be introduced to ensure small businesses and charities are not over-burdened.

44. HMRC indicated that it is already using technology to perform a more sophisticated analysis of VAT returns to identify rising levels of fraud in different sectors (Q 334). But this analysis is made only on the basis of returns submitted. A considerable lag can occur between the initial charge of VAT by a trader, who then disappears, and the recognition of fraud when traders later in the transaction chain request reimbursement of VAT paid.

45. Any new online system for reporting trade must be “hacker proof”, but it is clear from the credit card industry and from intra-bank payment systems that reliable technology exists to handle and transmit high volumes of transaction data in a secure environment. The collection of data (including the VAT registration numbers of the supplier and purchaser, the sales price, and the nature of the goods traded) at the time of transaction, as proposed by some witnesses (Q 304), combined with HMRC’s analytical capability, could act as first line of defence against an expansion of MTIC and other frauds. Alternatively, it could act as means by which legitimate business could gain “clearance to trade” and immunity from verification. We suggest that HMRC should undertake further work to examine the viability of real-time data capture of transactions by VAT-registered companies.

46. The Construction Industry Scheme, which sets out the rules for how payments to subcontractors must be handled by contractors in the construction industry, allows contractors to check the taxable status of

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32 An HMRC scheme setting out the rules for how payments to sub-contractors for construction work must be handled by contractors in the construction industry and certain other businesses.
subcontractors online. There appears to be no reason why this scheme cannot be extended to industry sectors where Missing Trader Fraud is common to enable legitimate companies to verify the status of their trading partners.

Collection of VAT in real-time

47. An extension of a real-time VAT monitoring scheme might see HMRC collect the VAT due as the transactions are made. Traders would be required to open a separate bank account, monitored by HMRC, into which they would transfer an amount equal to the VAT charged to their customers. This might happen automatically as part of the logging process, or the database could generate invoices for firms to pay within a short period. HMRC would pass a trader’s VAT claim for payment once HMRC were satisfied that the claimant’s supplier had deposited the VAT income—a strong incentive for purchasers to ensure they were trading with a reputable organisation.

48. Aside from the administrative cost, such a scheme might also create a shortage of working capital, as businesses would no longer be able to hold VAT income until their quarterly return to HMRC. This would particularly harm small businesses.

Containment or Prevention?

49. The proposals we have considered in this chapter could prevent MTIC fraud to some degree, but none will stop this crime. Furthermore, these proposals, like HMRC’s existing strategy, impose ongoing costs on business—either directly from increased administrative costs, or indirectly from cash-flow constraints caused by delayed verification of repayments. The Institute of Chartered Accountants in England and Wales likened extended verification to preventing a series of thefts at a windowless jewellery shop by controlling those who could walk past it, rather than putting glass in place (Q 173).

50. HMRC agree. They told us that “from an operational perspective … it is always the best solution to change the rules so that things cannot happen in the first place. Any enforcement activity is always going to be following on after the event or in response to a failure … of those rules, so getting the rules right … is obviously what we want to do. That is often easier said than done.” (Q 348)

51. HMRC’s current strategy has succeeded in containing MTIC fraud, but will not eliminate it; the Government sought the reverse charge derogation because HMRC’s current strategy is unsustainable. The reverse charge will stop MTIC fraud where it has been most prevalent, but we expect the fraud to migrate and mutate. Consequently we anticipate that when the UK’s derogation is reviewed in two years time there will be requests for the reverse charge scheme to be expanded, either to other Member States or other products, or both.

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33 This problem might be overcome if a system of “trusted third parties” is introduced to act as a guarantor for firms' VAT payments; however it is likely that these would place some cost on business. Similar systems are already used to collect Sales Taxes in some American states. Carousel Fraud in the EU: A Digital VAT Solution Richard T Ainsworth, Tax Notes International 1 May 2006.
52. The current mechanism for intra-Community VAT transactions is not sustainable. While the amount of money being lost in the United Kingdom may have fallen in 2006/07, mutation into other industry sectors will bring a subsequent rise in fraud levels. We believe that prevention is better than cure. A wide-ranging change to the VAT system is required and the Government should start discussions with the European Commission and other Member States on the form this should take. The next chapter examines some of the options for change.
CHAPTER 4: OPTIONS FOR CHANGE

53. The adoption of any of the measures in this chapter would require unanimous approval from the 27 Member States. The majority of our witnesses agree that some change is required, but there is no consensus on the form this change should take. We consider in turn five options that have attracted some support in the evidence we have received and which we consider to be viable proposals for change. These options are:

1. Generalised “reverse charge” or Sales Tax

54. We discussed the reverse charge accounting mechanism in Chapter 2 (see Figure 4). A generalised reverse charge 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 HMRC, and apply it as a credit against tax on sales made. The final buyer in a chain before the final consumer would become responsible for remitting all the VAT on that item. This would in effect replace VAT with a Sales Tax.

55. As already noted, the UK has secured a derogation to operate a reverse charge accounting mechanism in the mobile telephone and computer chip industries, and a Community-wide reverse charge operates for investment gold. A proposal whereby countries could choose to adopt a reverse charge mechanism on all products was put forward by the German Government, but it has not met with any support from the Commission and it does not appear that it will be pursued during the last weeks of the German Presidency.34

56. If, as we expect, MTIC fraud mutates or migrates to other Member States, it is likely that there will be further requests for derogations to apply a reverse charge to more products in other Member States. The European Commission would not be opposed to these if they were targeted and proportional (Q 135–137). Cross-border trade is likely to continue to grow as the Union expands and the internet facilitates international purchasing. Unless and until all high value/low weight goods, and service industries, are subject to a reverse charge fraud will continue to move into new sectors. A series of limited reverse charges would inevitably merge in time to a generalised reverse charge or Sales Tax.

57. The change from Value Added Tax to an “end user” or Sales Tax system would come at a considerable cost to both revenue authorities and individual businesses. It is also possible to raise more tax under a VAT system than under a Sales Tax. In a Sales Tax system, the whole of the revenue is collected from the final link in the commercial chain, when the retailer sells to the final consumer; this is commonly disproportionately made up of small businesses for whom tax collection is a considerable burden.35 Furthermore, studies have shown that a Sales Tax is efficient at relatively low rates but is increasingly difficult to administer as rates rise.36 Cross-border trade would

34 Austria supports the proposal. Other Member States and the UK are opposed to it (QQ 248–251).
35 The Government also noted that that the advantage of having the remittance of the VAT liability spread amongst numerous traders in the supply chain would be lost (Q 366).
36 Value added Tax: International Practice and Problems Alan Tait IMF 1988
become more expensive as firms would now pay the Sales Tax rate of the country of purchase. With increasing use of the internet for the purchase of goods, this would lead to firms being undercut by those based in the Member States with the lowest Sales Tax rates. Unless harmonised this would in turn lead to pressure from market forces for tax rates to be cut, and reduce the revenue raising potential of the tax.37

2. Destination System

58. Under this system the exporter charges VAT according to the rate applicable in the country of consumption or “destination”.

**FIGURE 4**

The Destination System38

<table>
<thead>
<tr>
<th>Member State 1</th>
<th>Firm A</th>
<th>Firm B</th>
<th>Member State 2</th>
<th>Firm C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sells</td>
<td>Buys</td>
<td>Sells</td>
<td>Buys</td>
<td>Sells</td>
</tr>
<tr>
<td>PRICE</td>
<td>100</td>
<td>100</td>
<td>200</td>
<td>300</td>
</tr>
<tr>
<td>VAT (10%)</td>
<td>+10</td>
<td>-10</td>
<td>+20</td>
<td>-20</td>
</tr>
<tr>
<td>NET VAT</td>
<td>+10</td>
<td>Overall: +10</td>
<td>In Member State 1: -10</td>
<td>In Member State 2: +20</td>
</tr>
<tr>
<td>TAX REVENUE</td>
<td>0</td>
<td>(+10 from Firm A, -10 from Firm B)</td>
<td>(+20 from Firm B, +10 from Firm C)</td>
<td></td>
</tr>
</tbody>
</table>

59. This system would require the exporter to register for VAT in each country to which he supplies goods. The European Commission told us that it is currently investigating this system as an add-on to the “one-stop-shop” proposal, currently under consultation, whereby a trader registers for VAT in his home country in respect of all VAT liabilities throughout the EU (Q 142). The taxpayer would file the VAT return electronically and either pay the VAT due directly to the revenue authorities in the destination country, or make one payment to his national bank, who will allocate it between the appropriate countries. There would be no need for a clearing house in this system.

60. This proposal would eliminate the opportunity for MTIC fraud. However, witnesses have warned us that there will be high additional compliance costs for business: exporters would need to be conversant with VAT rates (both standard and lower rates) and the rules governing deductible VAT in

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37 High Sales Tax rates encourage evasion techniques such as using or creating a business to buy goods tax-free when they are intended for personal use rather than resale. It would be likely that there would be more off-book “cash” transactions, which is already a common fraud in other sectors (Q 41).

38 Adapted from *Combating VAT Fraud in the EU: The Way Forward*, International VAT Association, March 2007
27 Member States in order to calculate the correct amount of VAT due (Q 192, 195). Similarly, there would be costs for revenue authorities who would have to provide information in most, if not all, of the official languages to the EU. Furthermore, it relies on the “one-stop-shop” proposal being adapted to cater for business to business transactions, and adopted by Member States, if the costs associated with separate registration in other countries are to be avoided.

61. For most companies, the compliance costs of a Destination System would be unacceptable and would act as a barrier to intra-Community trade, thus fundamentally frustrating the Single Market.

3.1 Origin System

62. The fundamental principles behind the introduction of VAT across the European Community, in respect of intra-community trade, included the eventual abandonment of the taxation of products in the country of destination in favour of taxation of products in the country of origin (the exporting country). This was accordingly proposed by the European Commission when addressing the removal of tax barriers in attaining the Single Market in 1993, but rejected by the Member States.

FIGURE 5

The Origin System

<table>
<thead>
<tr>
<th></th>
<th>Member State 1</th>
<th></th>
<th>Member State 2</th>
</tr>
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<tbody>
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<td>Sells</td>
<td>100</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>Buys</td>
<td>100</td>
<td>-10</td>
<td>200</td>
</tr>
<tr>
<td>Sells</td>
<td>200</td>
<td>+20</td>
<td>300</td>
</tr>
<tr>
<td>PRICE</td>
<td>+10</td>
<td>-10</td>
<td>+20</td>
</tr>
<tr>
<td>VAT (10%)</td>
<td>-20</td>
<td>+30</td>
<td></td>
</tr>
<tr>
<td>NET VAT</td>
<td>+10</td>
<td>+10</td>
<td>+10</td>
</tr>
<tr>
<td>TAX REVENUE</td>
<td>+20</td>
<td>+10</td>
<td>+10</td>
</tr>
<tr>
<td>TAX REVENUE IF CLEARING HOUSE USED</td>
<td>+30</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

63. Under this scheme, VAT would be charged at the rate of the exporting country and the purchaser would be able to request a refund of the tax paid from the revenue authority in its own country. This would mirror the position of a business selling to another business in the same Member State and would be logically consistent with the creation of the Single Market.

39 Adapted from Combating Vat Fraud in the EU: The Way Forward, International VAT Association, March 2007
However because of the wide disparity in VAT rates throughout the Community, it was recognised that there would need to be a transfer of the VAT collected by the supplying country to the purchasing country so as to restore the importing country's VAT revenues. This in turn requires the creation of a clearing house to facilitate transfers of VAT between revenue authorities.

64. The key attribute of the Origin System is its simplicity for traders: purchasers simply pay the appropriate VAT rate for the territory from which they are buying the product. The vendor only needs to know the appropriate tax rates in its own country. Charging VAT on intra-Community trades would eliminate the possibility of Missing Trader fraud as no participant in a trading chain would receive goods VAT free. However, VAT is designed to be a consumption tax and so this system is contrary to its underlying concept, i.e. that products should be taxed at the point of consumption.

65. A problem arises when the purchaser requests the refund of the tax paid from the revenue authority in its own country. Because the tax has been remitted in the origin country, the purchaser’s revenue authority is paying out money it will not receive unless and until it gets a refund from the revenue authority in the exporting country. This system of transfers between revenue authorities would be facilitated by the creation of a clearing house. The Commission’s original proposal for a clearing house suggested that the flows through it might be determined by broad macro-economic data, rather than relating information to actual trades. However, modern technology means that HM Treasury can envisage the latter option (Q 348) and it is reasonable to assume that this could be linked to a EU-wide real-time trade logging system should one be introduced.

66. Member States, however, continue to oppose the Origin System, as they did in 1992. HMRC have told us that some businesses support this approach but that zero-rating of transactions facilitates trade and is of great benefit to business and consumers (p 64, Q 258). HM Treasury expressed concerns that there could be difficulties for Member States in ensuring that they received the tax they were due through the clearing house, and noted that around £40 billion of VAT is associated with goods traded between the United Kingdom and the other Member States (Q 348). They believed there would be “considerable risks” associated with the system (Q 349).

67. The combination of an Origin System with a clearing house has considerable merit. The clearing house would be logistically feasible and greater sums are reliably and securely handled by the various clearing houses and payment systems operating in European financial markets. The interwoven nature of the European economy means that all countries would have an interest in ensuring that cross-border transactions are accurately recorded and verified, because all countries export to some degree. The risk inherent in having to trust other Member States’ revenue authorities, and the associated costs, should be lower than the risk posed by MTIC fraud and the associated losses.

68. We do not accept that the Origin System would automatically lead to a harmonisation of VAT rates in the Community although we accept that there is likely to be an adjustment in levels of cross-border trade as some purchasers switched to alternative suppliers in lower tax territories. The majority of VAT rates in Member States are already within a small range except for those products which are currently zero-rated in selected Member
States, where a large difference between applicable VAT rates would become apparent. The problem this creates would be circumvented by introducing a “Flat Rate” Origin System.

3.2 Flat Rate Origin System

69. Instead of the supplier charging VAT at the rate of the supplying country, the lowest rate of VAT allowed by the Principal Directive, currently 15%, would be charged. The purchaser would request a refund of VAT paid from revenue authorities in his country on his normal VAT return, who in turn would request a refund from the revenue authorities of the supplying country. The purchaser would need to account for the difference between the higher VAT rate in the country of destination and 15% by way of a reverse charge to ensure that VAT at the full rate of the importing country is paid by businesses who cannot recover their VAT in full. A clearing house would still be necessary but this proposal would meet the principal objection to the original Origin system in that it would avoid large transfers between the revenue authorities to account for differences in VAT rates. The transfer would need only to reflect the net position of trade flows between member states.

70. The Flat Rate Origin System removes several of the disadvantages of the standard Origin System. As VAT is charged at a single rate, the clearing house would only need to reflect the balance of trade between member states, and not different VAT rates. This would reduce the cost and complexity of the clearing system. Businesses would face no higher compliance costs than at present: vendors would change from charging a flat rate of 0% to a flat rate of 15% (or whatever flat rate level is set out by the Council of Ministers). Furthermore, there should be no political pressure to harmonise VAT rates, or remove derogations for zero-rated products.

71. There is still an opportunity for Missing Trader Fraud to be perpetrated under this system. However, by minimising the disparity of tax rates between imported goods and those traded within a Member State, the profitability of the fraud and thus its inherent attraction to criminal gangs would be significantly reduced.

3.3 Origin System or Flat Rate Origin System without Clearing House

72. This proposal would operate an Origin System or Flat Rate Origin System as described above but without the transfer of VAT revenues between member states through the clearing house. The VAT charged by the exporter would be collected and retained in the country of the supplier; the VAT would in turn be refunded to the purchaser in the country of destination. Net exporting countries would benefit from increased revenue flows at the expense of net importing countries, although this imbalance would be reduced if a Flat Rate Origin System were in place, because the rate of VAT refunded would never be more than the rate of VAT in the importing country. Furthermore, this system retains the “fractionated” nature of VAT,

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40 Only two member states, Cyprus and Luxembourg, currently apply this rate; however many Member States have derogations which allow them to zero rate some classes of products.

41 Partially exempt businesses which cannot recover all of their VAT would be the only purchasers affected by this measure, although as a control mechanism, all businesses would be required to make entries on their VAT returns.
whereby its collection is split between the member states in which value is added.

73. Without a Clearing House, VAT would change in nature from a pure consumption tax, but the cost associated with the clearing house and the risk associated with relying on other Member States to collect and remit tax revenue would be removed. There would be winners and losers from the change and HM Treasury did not appear to favour it (QQ 351–354). VAT would become payable on goods imported from another Member State even when those goods are normally zero-rated in the domestic market, increasing the cost of some goods in some markets. Countries running a trade deficit with EU partners would lose revenue; those with a trade surplus would receive more.42

74. In their evidence, HM Treasury gave three criteria for any new taxation system: that the right tax ends up in the right place; that the potential for fraud and non-compliance is minimised; and that business is not unreasonably burdened (Q 348). HM Treasury believe an origin system without a clearing house would fail on the first criterion. **We believe however that this proposal merits further serious study.**

A need for change?

75. **Harmonisation of VAT rates would remove the opportunity of MTIC fraud. The UK is not alone in opposing this harmonisation.** There appear to be three options for tackling MTIC Fraud: do nothing and accept it; take steps to make the existing system more robust and sophisticated; or accept that MTIC fraud is inherent in the system and accordingly reform the system. **Doing nothing is not an option. A continued ratcheting up of the complexity and compliance requirements related to the existing system will impose increasing costs on legitimate business. A solution to MTIC Fraud will benefit every Member State: countries need to recognise this and agree to act together. It is now time for the Government and other Member States to look more sympathetically at a radical change to the VAT system. The flat rate origin system proposal, either with or without a clearing house, merits further serious study of the potential impact on businesses, levels of trade, and Member State revenues.**

76. **We invite the Government, when responding to this Report, to assess the relative merits of all the options for reform which it describes.**

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42 The United Kingdom’s deficit for trade in goods with the EU in 2006 was £37.6 billion. If all traded goods were subject to VAT at the full rate (a generous assumption) this would have led to a potential loss of revenue of £6.6 billion for the UK. However, if a flat rate if 15% is applied to all imports and exports, this loss of revenue would be £5.6 billion: this is of the same magnitude as estimates of losses to MTIC fraud. There would also be considerable savings in administrative and compliance costs, and the system would be simpler for business.
CHAPTER 5: SUMMARY OF CONCLUSIONS

77. We recommend that Government works with other Member States to ensure that the Court of Auditors’ proposed changes to the Community Transit system are prioritised in order to attack the supply chain for this variant of MTIC Fraud. (Paragraph 12)

78. Missing Trader Intra-Community Fraud is occurring on a substantial scale across the European Union. We agree with HMRC that this is an outright attack on the tax system, and note that it precipitates other crimes, such as theft of consignments. We accept the evidence that the majority of the fraud is being undertaken by a small number of sophisticated criminal gangs. (Paragraph 19)

79. As things stand, HMRC has no option but to continue with extended verification; however they need to take real and substantive steps to ensure that their actions do not damage the innocent and are proportionate to the scale of the fraud. We note that, according to the Paymaster General, this approach has led to a “massive drop” in attempted MTIC fraud in 2006/07. This appears to justify their approach; however, the system of extended verification is an inefficient and unsustainable use of HMRC’s resources, and does impose a significant burden on smaller firms. (Paragraph 28)

80. It is generally accepted that the broad phenomenon of MTIC fraud is out of control; we expect it to continue to mutate into other sectors. (Paragraph 40)

81. We suggest that HMRC should undertake further work to examine the viability of real-time data capture of transactions by VAT-registered companies. (Paragraph 45)

82. HMRC’s current strategy has succeeded in containing MTIC fraud, but will not eliminate it; the Government sought the reverse charge derogation because HMRC’s current strategy is unsustainable. The reverse charge will stop MTIC fraud where it has been most prevalent, but we expect the fraud to migrate and mutate. Consequently we anticipate that when the UK’s derogation is reviewed in two years time there will be requests for the reverse charge scheme to be expanded, either to other Member States or other products, or both. (Paragraph 51)

83. The current mechanism for intra-Community VAT transactions is not sustainable. While the amount of money being lost in the United Kingdom may have fallen in 2006/07, mutation into other industry sectors will bring a subsequent rise in fraud levels. We believe that prevention is better than cure. A wide-ranging change to the VAT system is required and the Government should start discussions with the European Commission and other Member States on the form this should take. (Paragraph 52)

84. We believe however that an Origin System or Flat Rate Origin System without a Clearing House merits further serious study. (Paragraph 74)

85. Harmonisation of VAT rates would remove the opportunity of MTIC fraud. The UK is not alone in opposing this harmonisation. Doing nothing is not an option. A continued ratcheting up of the complexity and compliance requirements related to the existing system will impose increasing costs on legitimate business. A solution to MTIC Fraud will benefit every Member State: countries need to recognise this and agree to act together. It is now time for the Government and other Member States to look more
sympathetically at a radical change to the VAT system. The flat rate origin system proposal, either with or without a clearing house, merits further serious study of the potential impact on businesses, levels of trade, and Member State revenues. (Paragraph 75)

86. We invite the Government, when responding to this Report, to assess the relative merits of all the options for reform which it describes. (Paragraph 76)
APPENDIX 1: SUB-COMMITTEE A (ECONOMIC AND FINANCIAL AFFAIRS, AND INTERNATIONAL TRADE)

Sub-Committee A

The members of the Sub-Committee which conducted this inquiry were:

- Lord Blackwell
- Lord Cobbold
- Baroness Cohen of Pimlico (Chairman)
- Lord Giddens
- Lord Inglewood
- Lord Jordan
- Lord Kerr of Kinlochard
- Lord Maclennan of Rogart
- Lord Steinberg
- Lord Trimble (from 27 March 2007)
- Lord Watson of Richmond

Declaration of Interests

A full list of Members’ interest can be found in the Register of Lords Interests:

http://www.publications.parliament.uk/pa/ld/ldreg.htm
APPENDIX 2: LIST OF WITNESSES

The following witnesses gave evidence. Those marked ** gave both oral and written evidence; those marked * gave oral evidence only; those without an asterisk gave written evidence only.

** Association of Chartered Certified Accountants
* Belgian Finance Ministry
* Mrs Sharon Bowles MEP
  Charities’ Tax Reform Group
  Chartered Institute of Taxation
** Dr Michael Cheetham
  Earthshine Ltd
** Commissioner Kovacs, European Commission
** Federation of Technological Industries
** Mr Royston Ford
  Hassan Khan & Co Solicitors
** HM Treasury
** Institute of Chartered Accountants in England and Wales
  Institute of Chartered Accountants of Scotland
  Institute of Indirect Taxation
  The Law Society
  OCS SPF Finances Belgique
  OLAF
  Olympia Technology Ltd
  PricewaterhouseCoopers
* Vodafone

Additional written information was received from:

- Mr Geoffrey Lee

It has not been printed but is available for inspection at the Parliamentary Archives (020 7219 5316).

Supplementary evidence was also received from the following and is also available for inspection at the Parliamentary Archives:

- HM Treasury
- Institute of Chartered Accountants in England and Wales
- Olympia Technology Ltd

We would like to take the opportunity to thank all our witnesses for their submissions to our inquiry.
APPENDIX 3: CALL FOR EVIDENCE

The Sub-Committee, under the Chairmanship of Baroness Cohen of Pimlico, in the light of the Government's request to the Commission to apply for a derogation from the directive on turnover taxes to introduce a “reverse charge” system for certain products, has decided to broaden its continuing inquiry in the issues surrounding VAT Missing Trader fraud. The inquiry will seek to address the following key questions:

- What impact does this fraud have on the internal market?
- What are the measures currently applied in the UK and other Member States to combat this fraud and what are their weaknesses?
- The Commission has suggested measures including increased cross-border liaison by tax and law enforcement authorities and Governments, improved risk management, and mutual assistance by Member States wishing to recover unpaid taxes. Are these mechanisms adequate?
- Are Member States, within the context of the internal market and the globalised economy, capable of fighting individually against this fraud or is it right for the Commission to bring forward proposals on their behalf?
- Is it necessary to simplify or restructure the VAT system to prevent this type of fraud? If so, how might this be done?
- Does the adoption of measures to fight VAT fraud at the Community level undermine Member States’ control over the functioning of national fiscal systems?
- What would be the benefits and costs of moving from the current destination system to an origin system?

The Sub-Committee would welcome written comments on these issues. Witnesses who have already submitted material following our earlier call for evidence, are not required to repeat earlier submissions but are invited to submit additional evidence.

GUIDANCE TO THOSE SUBMITTING WRITTEN EVIDENCE

Written evidence is invited in response to the questions above, to arrive by no later than Wednesday 17 January 2007.

The questions above cover a broad range of topics and there is no need for individual submissions to deal with all the issues. Evidence should be kept as short as possible: submissions of not more than six sides of A4 paper of free-standing text, excluding any supporting annexes, are preferred. Submissions longer than this should include an executive summary. Paragraphs should be numbered.

Evidence should be sent in hard copy and electronically to the addresses below.

Evidence should be attributed and dated, with a note of the author’s name and position. Please state whether evidence is submitted on an individual or corporate basis.

Submissions will be acknowledged. Evidence becomes the property of the Committee, and may be printed or circulated by the Committee at any stage. Once you have received acknowledgement that evidence has been received, you may publicise or publish your evidence yourself, but in doing so you must indicate that it was prepared for the Committee.
Any enquiries should be addressed to: Simon Blackburn, Clerk of Sub-Committee A, Committee Office, House of Lords, London SW1A 0PW; telephone 020 7219 3616; fax 020 7219 6715; e-mail blackburns@parliament.uk.

This is a public call for evidence. You are encouraged to bring it to the attention of other groups and individuals who may not have received a copy directly.
## APPENDIX 4: GLOSSARY

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>EC</td>
<td>European Communities</td>
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<tr>
<td>ECJ</td>
<td>European Court of Justice</td>
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<td>EP</td>
<td>European Parliament</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>FTI</td>
<td>Federation of Technological Industries</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GNI</td>
<td>Gross National Income</td>
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<td>HMRC</td>
<td>HM Revenue &amp; Customs</td>
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<td>HMT</td>
<td>HM Treasury</td>
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<tr>
<td>ICAEW</td>
<td>Institute of Chartered Accountants in England and Wales</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>MTIC</td>
<td>Missing Trader Intra-Community</td>
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<td>NCTS</td>
<td>New Computerised Transit System</td>
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<td>OLAF</td>
<td>European Anti-Fraud Office</td>
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<td>SOCA</td>
<td>Serious Organised Crime Agency</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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APPENDIX 5: REPORTS

Recent Reports from the Select Committee
Prüm: an effective weapon against terrorism and crime? (18th Report session 2006–07, HL Paper 90)
The Further Enlargement of the EU: threat or opportunity? (53rd Report session 2005–06, HL Paper 273)

Session 2006–2007 Reports prepared by Sub-Committee A
Funding the European Union (12th Report, HL Paper 64)

Other Relevant Reports prepared by Sub-Committee A
Evidence from the Financial Secretary on the proposed reforms of the Stability and Growth Pact (7th Report session 2004–05, HL Paper 74)
Minutes of Evidence
TAKEN BEFORE THE SELECT COMMITTEE ON THE EUROPEAN UNION (SUB-COMMITTEE A)
TUESDAY 9 JANUARY 2007

Present
Blackwell, L
Cobbold, L

Cohen of Pimlico, B (Chairman)
Kerr of Kinlochard, L

Examination of Witness

WITNESS: MRS SHARON BOWLES, a Member of the European Parliament, examined.

Q1 Chairman: Good morning.
Mrs Bowles: I fear you are rather more advanced than we are in this matter at the moment.

Q2 Chairman: Not necessarily by any means. It is very good of you to see us. If we end up asking you things that you just have not got we would welcome your view.
Mrs Bowles: I think we can have a useful exchange.

Q3 Chairman: Would you like to start by making a statement or should we just start with questions?
Mrs Bowles: Just start, I think. The only thing I can say is, possibly, where we are in this Parliament in that the report came out in May last year, I think it was. It is not something that we have to respond to but we decided that we would be doing an own initiative report, as it is called. The problem with those is we are only allowed to have six on the go at any one time which means one has to wait for things in the pipeline to pass through, and although there is a certain amount of juggling, and I have in the last few months been agitating somewhat saying, “I think this ought to be going up the queue a bit”, realistically it is not going to be active in committee until February when we see off three other own initiative reports.

Q4 Chairman: When three others drop off the bough.
Mrs Bowles: It was only literally just before Christmas that I had discussions with our ECON Secretariat about setting up a hearing where we will invite experts from different countries to try and get a better pan-European feel for things. As I said, you are further ahead than we are in this in that at least you have had some quite useful submissions in from industry. It is only literally now that my mind is turning to getting ready for bringing it forward for the first exchange of views in my committee, which I do not really expect to be before the end of February or March at the very earliest. That is on the one hand. On the other hand, the Commission is quite desperate for us to say something particularly on carousel fraud, which leaves us in a slightly difficult situation trying to work out how to balance it because their report extends into other areas as well, excise duty and direct taxation. So, on the one hand we want to give a quick response on the things that are urgent and, on the other, a more considered response on the things that take longer. We have not even been able to discuss yet as to where the balance may come down. That is just the background of where we are at, so forgive me for being vague on some points and recognise that a lot of it is just out of my head and I am not really, as yet, able to speak for the committee.

Q5 Chairman: I am sure it will still be extremely useful because we, of course, are a House of Lords Committee and our findings do not bind, they merely get debated. Of course, the United Kingdom is by all accounts the biggest subject of VAT fraud so we may be able to be useful. If I could just start, and really it follows on from your introduction, by asking on what issues is the European Parliament's report into VAT fraud going to focus? Have you been able to establish whether there are different views across the Community as to how to tackle Missing Trader Fraud? Have you done that sort of background?
Mrs Bowles: No. All we have got at the moment are the reports that we have, for example, as you might discuss a little later; what has come out of ECOFIN, what are the stances that the different Member States have taken, so in a sense that filters through to you and I do know from colleagues how they tend to line up, but there is nothing different there from what one might have expected. We need to respond to the points that the Commission essentially raises, which seem to me to cover the area of administrative cooperation, and I know you want to talk about that later on as well. I did wonder whether quite a lot of the administrative steps that could be taken might well be within Member State competence to do them anyway, in as far as they relate internally to one Member State. An obvious thing that could happen might be tightening up registration requirements in some way, more ongoing monitoring of companies, I suppose this is the risk analysis, looking at frequency
of reporting, but then in the UK I believe if you want to have monthly instead of three monthly VAT returns with good reason that can be demanded. The other interesting idea is about trying to get authorisation for large refunds in advance but, again, these would require quite a lot of updating of the systems so that you could almost be doing it at the press of a button.

Q6 Chairman: I wonder if we should start, as you have suggested, from what happened at ECOFIN. Mrs Bowles: Yes, possibly.

Q7 Chairman: I was going to raise it later but maybe that is where we should start. Mrs Bowles: My understanding of the situation really is that Austria and Germany are quite keen on having reverse charge across the board for everything whereas the UK wants to have it in sectoral things that are subject to this kind of fraud. It has happened for some while that we have had reverse charge in the construction industry and the next move is to mobile phones and computer chips. My understanding is that at ECOFIN there was some reluctance to grant derogations partly because of a confusion that some countries were asking for rather a lot. I understand France was very concerned that all one might do is decamp the fraud from the UK to France. That is a valid concern, and I have heard some lawyers in this area say it is a valid concern, but almost immediately ECOFIN was over we discovered that France had suddenly got some missing billions too and they have discovered maybe they have got the fraud there already.

Q8 Lord Cobbold: Surely any solution must be a total solution to this problem. If you just have a derogation in certain commodities in one country that is going to push the thing either into other commodities or into other countries, is it not? Mrs Bowles: I think there is a risk of that or there is a risk that if you do derogations in one sector then you just move the fraud into another sector. I am told that in times past there used to be vans of goods driving around crossing borders on this side of the Channel. We cannot do it on our side quite so easily. This is not new. What is new about it is possibly the scale.

Q9 Lord Cobbold: The extent of the problem. Mrs Bowles: And the fact that there are now possibly more high value consumer goods, like the computer chips, the mobile phones, that lend themselves to it because of the ease with which they can be moved around, if they ever are because sometimes we think it is just a paper trail. I have heard it rumoured that to some extent the Germans wanted to do something significant on this in their own Presidency and maybe, therefore, they did not mind it carrying over. Certainly it is something that has been mentioned in the context of the German Presidency, that they are keen to tackle this but, of course, you have to take it that they are keen on an across the board reverse charge mechanism and that does have other implications that not everybody is happy with.

Q10 Lord Blackwell: I wonder whether one of the starting points for this needs to be a better understanding of what the scale of the problem is and whether that is something your investigation might look at. We have seen figures that put the UK at the top of the league and even in the UK there is a dispute as to whether it is one billion, three billion or 12 billion pounds. Mrs Bowles: Eight billion.

Q11 Lord Blackwell: There may be something about the physical separation of the UK that makes it easier to achieve. On the other hand, the UK has probably got more rigorous reporting systems than many other countries and it is slightly incredible that there should be such an issue of fraud in the UK and that other countries—Italy, Greece, Spain, et cetera—do not have the same scale of problem. In order to get focused at the European level on tackling this and what the scale of the problem is, is this something that your committee might do to try and get to the bottom of this? Mrs Bowles: I am not sure that we necessarily have the resources to be able to commission those sorts of figures; it is something the Commission is better able to do. We had a meeting with Commissioner Kovacs, I think it was in November, and he said that he estimated the EU was losing €250 billion on fraud. To put that in context, that is five times the CAP, so we can moan all we like about the CAP but there is this amount. This would mean that the figures for the UK of eight billion, 10 billion pounds, might be the case. I agree with you that the UK may well have a better system of checking up on this.

Q12 Lord Blackwell: We may just be more aware of the problem. Mrs Bowles: Yes. It is hard to believe that it would not exist in other countries in particular if, as the Commission sometimes says, a lot of it is organised crime that is doing this. Why would they target particularly the UK, there must be other countries especially if their regimes are not as tight as ours for tracking things down. If it is organised crime then they are going to go everywhere I would have thought.

Q13 Lord Blackwell: Which then leads on to our second question here which is depending on the scale of it and the way it is being driven whether you think the thinking here will focus on just dealing with the
criminally and trying to stop people breaking the law or whether it needs fundamental changes to the VAT system, such as reverse charging, in order to stop that?

Mrs Bowles: It seems to me that we are going to have to have a double plan, a two stage process. Initially we are where we are with the VAT system that we have got, which does seem to be designed to have this loophole if at the point when you cross the border there is no VAT applied.

Q14 Lord Kerr of Kinlochard: Can I ask you a question about that. At the beginning there were quite a few Member States who agreed with the Commission’s original view that the VAT should be charged in the country of origin. You could argue—the UK has always been against this—that with the increase in cross-border trade and the increase in proportionate cross-border trade, which is high value goods now, the arguments for an origin-based system have increased. That would be a very fundamental reform which no doubt would have other downsides, but an upside would be that it would put an end to this form of crime, would it not?

Mrs Bowles: It would. It is something that I would certainly want to look at along with other things. It was the original view of the Commission to do it that way and in the past the Parliament has been supportive of that view—this was well ahead of my time here—because to some extent that is a bit more like other aspects of the Single Market. The problem comes about from a variety of areas as far as that is concerned in that if you apply it on the country of origin basis are you going to continue to do a tax refund cross-border, input and output, in which case if you are in the UK are you going to try and reclaim from France, the answer is no, you try to reclaim from the UK and then there would have to be some kind of clearing system. I think that was dismissed in the past as too expensive. If this €250 billion figure is anywhere near realistic then the cost of running such a clearing system should become viable if one can recover a substantial proportion of those costs. You could say why can you not pay the tax in the country that the activity relates to, it should benefit from that tax, why does it all have to come at the consumer end, but that would be quite a reverse of things that were decided back in the 1960s. If one did something like that and you did not have a clearing system and you just said, “That was the element that was in France, France keeps it”, it would shift the level of revenues coming into the different treasuries. I think the original analysis showed that Germany and the Benelux countries would gain from it. Anything that is proposed has probably got to be income neutral vis-à-vis the Member States because I cannot see any Member State wanting anything different from that. Looking into proposing that we go to this country of origin with a clearing system is a possibility, but that is a long-term solution and we probably need to have something now even if it is just more derogations, or across the board derogations, greater co-operation and those things that can be done, if you like, more or less straight away whilst one looks further at whether we can get more support for either across the board reverse charge or going to country of origin. My instincts are with country of origin, I have to say. Member States also fear a clearing system for other reasons. It may be is there insufficient trust in one another’s mechanisms? I know on the ECON Committee there have been several times when I have proposed something be done in the way that it is done in the UK, let us say, and a colleague from another party in another country has said, “Well, yes, I would agree with you if we had the FSA but we do not and, therefore, we are not so quite so happy with that approach”. There are differences. There is suspicion, maybe some people would suspect that the balancing would not be done properly. I do not think those are well-founded because you have to have clear of other things between countries, between central banks and so on, so why should this be any different. I think it merits looking at again.

Q15 Lord Cobbold: Given the amounts involved it really is important to do something to increase the priority and find some sort of solution to this. Would you agree that it has to be on a Community-wide basis to make sense, individual countries probably cannot solve this on their own?

Mrs Bowles: That is probably the case. I think it is a mixture of things. Increased vigilance in each and every Member State as to what is happening within its Member State has to help. If one looks at how the VAT registration system works and whether there is any tightening that can be done there, that is not oppressive, then that is a possibility, but one has to handle all these things with care because if one started tightening up, especially in the area where it is going cross border or you are trying to check up on “are my supplier companies and my customer companies going to be honest and pay up their VAT or are they part of some carousel” you could end up with a situation where you have quite a chilling effect on trade and commerce and, indeed, on the Single Market because the chances are you know the companies in your own country, and so on, maybe better than ones in other countries. If one starts to build in a culture of suspicion of one’s potential suppliers and customers through the checks and balances that you introduce because of VAT fraud then one could end up being very damaging to competitiveness and not in line with the Lisbon objectives. This is something I have only just started thinking about having started to look at possible things that might be done to tighten up.
Q16 Lord Cobbold: It could require a complete reform of the VAT system.
Mrs Bowles: Yes, but I do not think there is a willingness in Council for that. I think this is where there is an institutional impasse that has gone on for many years with the Commission and the Parliament, for example, being happy to go to the origin principle and that not being anything that one could get through the Council because Member States are just so sensitive in the areas of taxation and revealing more about one another’s taxation to one another. This is something I would quite like to develop myself in exploring this as to why in this area where we have these problems should there be such concern, why can we not trust that a suitable clearing system could be set up. Okay, I accept there was an expense but now, with the level of fraud, if that would work then surely it is better.

Q17 Lord Blackwell: The other option would be to go completely the other way and effectively replace VAT with a straight sales tax. Paradoxically, as you think about it, given that now we have low import duties into the EU on most manufactured goods you end up paying more tax if more of the value-added is within the EU than you would if you import a large amount of the material and just finish it in Europe. As I think about it, if we were reinventing this I am struggling to think why we would want a VAT system rather than a sales tax system when a sales tax system would be an awful lot easier to administer.
Mrs Bowles: I have struggled with that thought myself in that I think one could examine the whole theory of whether you even want it as a consumption tax, as I have said. That might be a very nice theoretical exercise, but—

Q18 Lord Blackwell: It is not on the radar screen of anyone here.
Mrs Bowles: Things within the EU tend to move rather more incrementally and that would be pretty revolutionary, would it not? The sales tax is another idea and I suppose if you are going to an across the board reverse charge that is what you have got in the end anyway.

Q19 Chairman: Yes, fundamentally.
Mrs Bowles: I did pose this question to a couple of the people from the Commission who are working on this and I said, “What evidence have we got from countries where they use a sales tax?”, the obvious one being the United States, and this is something I would like to have a look at independently anyway. They said that the evidence of fraud through, if you like, goods disappearing and I suppose going on the black market sales tax free, they reckoned was quite high and some of the states in the US were claiming that it was as high as 40 per cent, which seems staggering because I had not heard about it. I would have thought that I might have heard about it if it was 40 per cent.

Q20 Chairman: Absolutely, yes.
Mrs Bowles: I am not saying they were telling fibs, I think they chose the most extreme case, but I think the US is the obvious place to look for some of their statistics on sales tax to see what does go missing and how. The other point, I suppose, is people are then concerned that you have not got the incremental aspect, if the trader or the retailer goes bust at the end of the chain then all of the VAT goes missing or all of the sales tax goes missing, whereas with the system of input and output you have usually collected something along the way before it goes bust unless you end up in the missing trader situation.

Q21 Lord Kerr of Kinlochard: That is clearly right. On the other hand, a sales tax system is much simpler.
Mrs Bowles: Yes.

Q22 Lord Kerr of Kinlochard: Simplicity maybe has advantages.
Mrs Bowles: It depends whether the fact that at the warehouse stage the goods are all VAT free causes greater incentives for disappearing goods and without some kind of statistical analysis I cannot call that. Possibly if the Germans and the Austrians are as keen on reverse charge mechanisms as they are purported to be they will have done some investigation into this already as to how it might happen within their own countries anyway and we could dig that out.

Q23 Chairman: Can I just have a little prod at the whole question of reverse charging. If enough of us seek a derogation we have changed the system, have we not?
Mrs Bowles: Yes.

Q24 Chairman: I take it that if the extent of fraud is as bad as we think, and the UK is only admitting to something between £3.5 and £4.7 billion in the Autumn Statement, but I think we all think it is probably a bit worse, if enough of us do this then we have changed the system. I suppose I conclude that if it is as bad as this and if fraudsters, as we know they do the minute you tighten up enforcement in one country or reverse charge in one country, move to another, incrementally we have arrived quite quickly at a sales tax. How is your report going to work? I can see that it must be going to cover the various methods of tightening up or enforcement. There will be a perfectly good report to be written that says, “We have all got to do this, tighten up and enforce”, but then there are a lot of people out there with
Lord Blackwell: It is probably easier for a fraudulent trader to prove that they have had a cargo of phones going through than to prove they have delivered services worth umpteen million pounds.

Mrs Bowles: Yes. You have got to be quite a big professional organisation to deliver services of that nature, so you are going to be regulated by other means or have other constraints upon you, that was why I was curious about them saying that. I was wondering whether it was more to do with things like mobile phone services, the telephony services, and could bandwidth be going round in a carousel kind of thing. That was the only thought I had, as to whether those were the kinds of Services they were thinking of. It is something we have to look at. I think the Commission is hoping that we will come up with a suggestion, “Well, these are things you can do now, so go and do them now, and these are things we need to have more detailed work on that are longer term”. For example, say we had agreement in principle and we knew the Member States were happy to change the VAT system, how long do we think it would take the Commission to draft it and come up with a proposal and for it to go to the Parliament? We would be into the next mandate. I cannot see anything like that happening on less than a five year cycle.

Q25 Lord Cobbold: And to services as well.

Mrs Bowles: I have noticed that people are saying there is this risk of carousel fraud happening within services but I have not got my head round how that happens. Again, that is something I would like to know more about so maybe I will ask some of the accountants and auditors who are involved in these things because if that is the case obviously it is easier to carousel services where nothing moves than it is a mobile phone or a chip, in which case one would presumably big time be having to look at things that—

Mrs Sharon Bowles

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derogations. If I were writing this report I am not quite sure I could see how I would proceed either. Mrs Bowles: I think that is why the Commission are waiting to see what we will say because they are not quite sure how they want to proceed either. We know the problem, we know how it comes about and there have been some very good expositions on this in some of the submissions to your own inquiry, the question is how quickly do you clamp down. It is an interesting thing that if maybe instead of an individual country saying, “We want to derogate for mobile phones”, the whole of the EU said, “Okay, let’s have a derogation on mobile phones”, instead of it being mobile phones in the UK and something else somewhere else, you would have the interesting scenario in a sense of for a while some goods being reverse charged and some not if you said “It is totally reversed for those goods” and you could end up with a rather mixed system that is a bit confusing. One advantage of doing it in a piecemeal way like that if it did move towards a total reverse charge system is that it would soften the blow that the treasuries would receive because if you go to reverse charge they are going to get delays in receiving their money. Under the present system they have been getting some as it goes along. I do not know whether anybody has done a computation of this but it is something I would ask the Treasury, that if they switched to an across the board reverse charge what is it going to do to their cash flow. It may be that it is not so much because whilst it is in the supply chain it is going on both sides of the VAT return, so it may not be as big as I fear but I strongly suspect there could be a bit of a cash flow problem that might be significant to treasuries there. Going in a piecemeal way would soften that.

Lord Blackwell: I do think conceptually there is a problem with trying to specify bits of equipment that reverse charges apply to. You could just imagine you ban mobile phones so it moves on to MP3 players, you ban MP3 players and it moves on to small flat screen TVs or whatever it is. There is always going to be a new product and the law will continue to be running to catch up.

Q26 Chairman: Perhaps this is the moment for me to ask a question about enforcement type things that could be done. We wondered about the introduction of “joint and several liability” for firms which are acting legally but inadvertently trading with a fraudulent person down the road, placing the liability on the firm, as it were, to make sure they are not engaging in carousel fraud. Is this the sort of thing that the Commission is likely to see as a proportionate response or are they going to think we have all gone mad?

Mrs Bowles: They mentioned it in their paper but pointed out that you have to sail within the ECJ decisions and there is a problem there in that what came out of the ECJ was not terribly clear on that, it tended to be rather subjective rather than objective, so how is a firm supposed to have certainty. I think it was on thinking through this that I came to the point that I rehearsed a little bit earlier, that if you are in business and you start having to check out the credit worthiness of your supply chain on both sides in order to demonstrate that you did a credit check, so that you can be deemed not to be responsible because you did the checks, that is a huge change to the way business is done and, frankly, for small businesses it is going to be difficult, or you are just going to have pieces of paper exchanged that do not mean anything.

Q27 Chairman: A risk assessment.
Mrs Bowles: Having run a business myself, I know that every now and then I would go and try to buy something from somewhere and all of a sudden they would want references as to whether I was credit worthy or not. It was actually quite a nuisance and one chose to go and get it somewhere else. It was particularly irritating when you were trying to pay cash for something, or not cash but a payment that was not going to be bounced in any way.

Q29 Lord Blackwell: This is the last resource of governments really, is it not, to try and impose the burden of running the tax system.
Mrs Bowles: Yes. I have to say I think that the UK has been very overbearing on this and even despite the ECJ judgments it comes to my ears that there are instances of closing down on firms. You only have to have the finger of suspicion pointed at you to not get your VAT refunds and business stops.

Q30 Lord Kerr of Kinlochard: I understand why the Court of Justice were not attracted by joint and several liability, and the Commission, say they would be prepared to look at it but only against the background of that case in the Court, so clearly they are not going to go down that route. They seem to stress that the short-term requirement, say within your second category, things that could be done now, is for better mutual co-operation between Member States. I would like to draw you out on how you think that would work. They talk about an “e-monitoring system, on the basis of quantifiable indicators, in order to ensure that each Member State is able to and actually does provide efficient assistance to other Member States”. Is that the tip of an iceberg of real ideas or is it a pious hope? How would an e-monitoring system on the basis of quantifiable indicators deal with, say, the problem of carousel fraud? I cannot conceptually get it.
Mrs Bowles: I am not sure that I can in some respects. When I read through that again I was confused as to whether they meant that to apply to the VAT situation or whether they were talking about the direct taxes situation because if you look at the relevant part of the paper it also said that they thought as far as VAT was concerned it would work in quite well. That was on page five, section 2.4. It says: “The Community legal framework in the field of administrative co-operation on VAT and excise duties as such appears to be satisfactory from the Commission’s point of view. Even if improvements on specific points may be necessary . . .” I think they think they have got sufficient of a legal framework there but maybe more could be done. Then the part that you mention, I think, is over the page, on the top of page six, where we get on to the monitoring system in avenues to explore. I am not quite sure whether that is meant to be generic to all areas because later on down that page they go on “As regards VAT” as if the last bit was not VAT, so I am slightly confused as to what might be going on there.

Q31 Lord Kerr of Kinlochard: What is clear is they end up on page 10 saying: “. . . at this stage fraud could better be controlled through joint action by the Commission and Member States and through an efficient and modern organisation of the control system”. I have not seen in their paper a description of that efficient and modern control system.
Mrs Bowles: No.

Q32 Lord Kerr of Kinlochard: If carousel fraud is on the scale of the estimates that we hear about, I do not see how just doing what they are doing now better, in the form of mutual co-operation between national fiscs, is going to deal with the problem.
Mrs Bowles: I am not sure about that either. It would seem to me that in detecting carousel fraud what is important is speed of information, which means the Member State where the refund is being sought, because that is the trigger where you might notice it, so anything that can speed up, if you like, being put on alerts that “here is a big request for a refund, is this a new organisation” and so on, possibly at that stage if there has been a cross-border movement of the goods you might want to suddenly check upon what the nature of the firm is in the first country and that there may be some greater assistance there. Realistically you are not going to pick it up whilst you are on three monthly VAT returns unless you can move to some kind of more real-time system within a Member State so that you get authorisation for big refunds, which would take away the onus from the adjacent businesses if they were innocent. It seems to me that instead of putting the onus upon them to be doing the checking you should probably be putting the onus on to the administration on the basis of “if this much money is going missing it should pay for itself”. Then if you are in one of these carousels where it is jumping over the border, going round several times and all over the place and you are trying to track the people down in terms of the fraud aspects, you need to link up with other countries. I am not quite clear how having more numbers about the amount of trade that is going on between certain Member States is necessarily going to alert you all of a sudden to a trader because surely it is going to be submerged unless you have a horrendous VAT return to do where you are going to be listing every person that you have dealt with and then who is going to be inspecting these. Unless you are realistically saying we have got to go to some really heavyweight everything is on-line, real-time with advanced data mining techniques going on all over it, that might be possible some time in the future but I really do not think we are there yet.
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Q33 Chairman: Can I just pull this together because, unfortunately, we are running out of time. Impliedly, Mrs Bowles, you have said to us that you do not really think this is something that can be tackled individually, it has got to be done EU-wide.

Mrs Bowles: Yes.

Q34 Chairman: That is where we start, if you like.

Mrs Bowles: Both in terms of co-operation and, of course, if we have a significant review of the system then—

Q35 Chairman: It is not individual states?

Mrs Bowles: No.

Q36 Chairman: There has been a tendency to say to the British, “It’s all your own fault, get on with it”. Mrs Bowles: I think quite often there are things going on that we have detected that other countries have not detected yet. I have found this in other directives. On the Payment Services Directive most Members here are saying they do not have money remitters in their countries.

Q37 Chairman: Oh, yes they do. We hoped to find time to ask you about the other issues that the ECON Committee will be looking at in 2007 but you are joining us later and maybe we can do that then.

Mrs Bowles: There is plenty going on.

Q38 Chairman: We can do that informally because we would be very interested particularly in the question of the future funding of the EU and is there a consensus?

Mrs Bowles: I am not sure that is an ECON issue, I think that is more budgets and constitutional.

Q39 Chairman: If you have any got any clues we would certainly be interested in hearing what else the ECON Committee is looking at because this could readily guide the work of this Committee.

Mrs Bowles: There is a list of things I have done so I can bring that along.

Q40 Chairman: That would be wonderful.

Mrs Bowles: I do not get involved in absolutely everything but even the list of things that I am involved in seems to be about ten.

Lord Blackwell: Just to add one thing on the VAT fraud discussion, which is we were talking about the comparison with the US and the fact that your committee might look at the way that sales tax works in the US. There is a lot of VAT fraud which does not fall under this carousel impact, either black market or not, so when you look at sales tax fraud in the US I am sure that a lot of that will be simply people supplying services without—

Chairman: Like builders.

Q41 Lord Blackwell: Like builders, yes. We need to make sure if we are doing that it is on a like-for-like basis.

Mrs Bowles: Yes, I agree. Within the ambit of my report, of course, I think I can deal with that type of fraud as well because it should be looking wider. Who pays VAT on their services that they purchase into their house? Because I am a politician I go out of my way so to do and it makes some of my suppliers think, “Who is this weirdo?”

Q42 Lord Kerr of Kinlochard: We need to think about the timing of our report. If you are going to do both halves of the menu, as you have described it, a first course of things that perhaps one should be looking to for the longer term and a short-term fixes bit, you have got quite a big report there. When do you think it will be completed?

Mrs Bowles: That is my problem and I think I am only at the stage now of beginning to think about this. I will probably take views of some of the other people from the committee as to what we do. Because the Commission is so keen for us to say something, I think they would like to get something else out this year which would cut my time down to literally a few months, in which case I would be saying to them, “Go ahead and bring out a White Paper on some of these other issues” because I do not think it is down to me to solve them.

Q43 Lord Kerr of Kinlochard: I agree.

Mrs Bowles: But they can be given some green lights to go ahead with the quick fixes and come back with some more coherent and concrete proposals on some of the long-term measures. I think I will probably have to end up compromising a bit like that in order to get it done in a short-ish timeframe. It would be lovely to say, “Let’s spend a year on doing it”, but I will not be given the luxury of that, unfortunately.

Q44 Chairman: You could at least end up pointing them towards some of the longer term things, saying, “Here are the quick fixes and the longer term things”. Mrs Bowles: Saying “Come back with a Green Paper or a White Paper on some of these issues”. I am sure this is the beginning of that process. Whether they manage to take it all the way through to a directive, let us say we were to radically change the system in some way we would have to have those papers and be looking at it again so I am sure we will be sitting opposite one another again looking at it.

Chairman: It seems very likely. Thank you very much for having us.
Wednesday 10 January 2007

Examination of Witnesses

Witnesses: Mr Rudy Volders, Director, and Mr Yannic Hulot, Fiscal Co-ordinator Research, Belgian Finance Ministry, examined.

Q45 Chairman: Good morning, it is very nice to see you.
Mr Volders: Welcome to this meeting concerning VAT fraud. I am perfect in French and in Dutch but in English it is going to be difficult for me. I understand everything but speaking I am always looking at the TV and American films and it is English that everyone understands but for the rest it is very passive. Excuse me for this annoying situation. The Secretary of State, Mr Jamar, is going to come later. There is an urgent meeting at the Parliament because he is also responsible for corruption and OECD and he must now defend before the Parliament the project of law is compliant with the OECD evaluation of Belgium. The Minister of Justice has demanded that he appear. He is sorry about this but he is going to arrive. It is 10.15 and I think he is going to be half an hour. He will immediately come back and you can meet him. For the technical aspects I have invited Mr Hulot who has undertaken the study that has caused much ado about nothing.

Q46 Chairman: That is very English!
Mr Volders: Much ado in the government of the UK and also in the Parliament. I think the Parliament wants more explanation as to why the Belgians—It is not why the Belgians, we have been contacted by James Oliver of the BBC—

Q47 Chairman: For the Panorama report.
Mr Volders: Yes, for the Panorama report. That was the introduction. He said in the Belgian Parliament Mr Jamar had defended the politics of Belgium to cope with the VAT fraud and we mentioned this study. The journalist knew this and he contacted Mr Jamar and Mr Jamar gave an interview to the BBC journalist and then we had a diplomatic incident. We have spoken with the Ambassador and we are open to discussion to defend our position and certainly to explain our politics to fight against VAT fraud.

Q48 Chairman: We will start as if we had Mr Jamar here. May I thank you for having us. Thank you for filling in for Mr Jamar, who we look forward to meeting later in the morning. We are recording all of this because we are a House of Lords Committee and I hope that is all right. You will get a transcript so you can see what it is that has been said.
Mr Volders: No problem.

Q49 Chairman: I believe you have also had a list of the questions that we hope to ask and, indeed, very appositely the first thing we wanted to ask you about was the work of the Task Force because that must have been the core document from which Panorama drew their figures and their facts. In fact, we have not got a copy of the report and we would be terrifically grateful for it.
Mr Volders: A copy of the report?

Q50 Chairman: Of the report on Missing Trader Fraud.
Mr Hulot: It is only available in French.

Q51 Chairman: That is all right, we can get that translated.
Mr Volders: We are copying it now.

Q52 Chairman: Good. None of us is fluent enough in French.
Mr Hulot: We have a short résumé about the Eurocanet project.
Mr Volders: That is in English!

Q53 Chairman: Wonderful. That really constitutes our first two questions. What we are beginning to find is that there is some disagreement about the size of the fraud. We have, as it were, in the United Kingdom owned up to somewhere between £3.7 and £4.5 billion lost through carousel fraud. We owned up to that in the Autumn Budget statement but, for instance, your figure of eight billion is rather higher than we recognise. Then there are reported comments from Mr Kovacs who says it is 250 billion which would be five times the size of the CAP. We would like your views on where the numbers are and where they are coming from and what you think about Eurocanet.

Mr Hulot: Eurocanet is a detection method, not an evaluation method. It is a network between all the Member States between anti-fraud units about the fraudulent transactions. If we have a transaction from Member State one to Member State two, to Member State three, Member State four, we have the
companies which are targeted. The aim of the project
is to monitor closely electronically the companies
which are invoicing constantly to missing traders.
With that data it is possible to make a reproduction
of where the missing traders are in the EU. Do you
understand what I mean?

Q54 Chairman: Yes.
Mr Hulot: It is possible to do a reproduction. With
the network it was possible to make this study, and
we did it. The first conclusion is that VAT fraud is not
homogenous in the EU, there are big differences.

Q55 Lord Watson of Richmond: Differences in how
it is done?
Mr Hulot: Yes. It was not a study about the VAT
fraud in the UK, it was a study of data and we have
very good data. It is perhaps the first time in the
European Union that we have had the data to make
the study. If Mr Kovacs says it is €250 billion of fiscal
fraud and €60 billion of VAT fraud, I do not know
if he has got data to say that, but to do the study we
did we had data and we had data from 23 countries.

Q56 Chairman: That says, to me at least, that the
Eurocanet data is probably better than anything else
that is around because you have collected it from the
people who are actually directly dealing with the
data.
Mr Hulot: Yes.

Q57 Chairman: Is there any chance that the amounts
are double-counted?
Mr Hulot: Normally not. We made a filter to avoid
double-counting. Also, we had a problem with the
Dubai route because all the fraud which we called
the “Dubai route” was in the UK. We were in
communication with all anti-fraud units in the EU
and we never had a case with damage out of the UK.

Q58 Lord Watson of Richmond: May I ask a
supplementary. However, there is this enormous
discrepancy between your figure, which is bad
enough, and this other figure which is hundreds of
billions. It prompts the question whether what is
actually happening here is that we are really only
beginning to look for this fraud and that it may be
rather like an iceberg, that we have detected what is
on the surface but we have not actually discovered
the dimensions under the surface. Do you allow for
a possibility that the extent of VAT fraud, and carousel
fraud in particular, may be much, much greater than
that has been anticipated?
Mr Hulot: I think last year we were at the top—

Q59 Lord Watson of Richmond: You had never done
that research before?

Mr Hulot: No. I have to say we saw the figures for the
first quarter to 2006 and the transactions went down
from 70 per cent, and also in the UK. That means
that the study gave some figures and now it is not the
situation we had then.

Q60 Lord Watson of Richmond: It is less.
Mr Hulot: Yes. The reason we know was there was
the First Curacao bank which closed and on the
Dubai route everybody had an account in this bank.

Q61 Chairman: The bank was in Curacao, not
Dubai.
Mr Hulot: Yes, Curacao.

Q62 Chairman: One in Dubai as well?
Mr Hulot: Yes, but it was for the fraud that we call
the “Dubai route”. It was the Dubai route but—

Q63 Chairman: It was banked in Curacao.
Mr Hulot: The accounts were offshore in Curacao.
This fraud disappeared in September. In the study the
Dubai route represented 66 per cent of the fraud in
the UK which means these figures have disappeared.
We imagine now the fraud in the UK is at least a third
less than last year.

Q64 Chairman: Can I ask who has been providing
the Eurocanet figures from the UK?
Mr Hulot: To evaluate the fraud in a country you do
not need the data from the country but you need the
data from the other countries and we had the data
from all the other countries.

Q65 Chairman: Including the UK?
Mr Hulot: No. We have a problem with the UK.

Q66 Chairman: Do tell me, why?
Mr Hulot: At this moment the Eurocanet network is
a very good detection method but for one year we
have had no data from the UK, they do not want to
participate and we do not know why. The UK is the
one that is of more concern and we have contacts but
we have no data, no feedback about the missing data.
We send the results from all the other countries, they
have the results, but the UK do not participate and I
do not know why.

Q67 Chairman: Oh dear.
Mr Hulot: We have contacts in the Ministry of
Finance, we have contacts in CCT and also with the
FLO. If you can help us to have good contacts and
exchange of information.
Lord Watson of Richmond: If I may say, this is quite
extraordinary. I do not know whether you saw
yesterday’s Financial Times.
Chairman: It is one of yours.
Lord Watson of Richmond: Yes. There is a trader in Britain who has been sentenced to 15 years in prison and his two colleagues seven and a half years each. He is actually, by nationality, French and Belgian but he has been carrying out his fraud in the UK. There is a name given to the person who has been heading the investigation, not just of this but all these investigations, for the Revenue and I am just wondering why you have not had contact with him. He is Mr Chris Harrison, Deputy Director for Investigations at the Revenue. You should contact him. You could ring him up this afternoon.

Mr Hulot: Perhaps that is the case. You have to know that the project works in 23 countries in the EU and everybody is very interested and have invested in the project. In some countries they have created teams to work in Eurocanet and we have contact points which are working in Eurocanet full-time. It is a very early method of detection. With this method we can detect six months earlier than with other methods.

Mr Hulot: Yes, but apparently they do not know very much of the project and they fight against fraud but with other methods.

Mr Volders: They do not believe in the Eurocanet method but that is strange. Is there another country with the UK that is not participating in Eurocanet?

Mr Volders: Mr Volders: Yes, we also have a problem, a political problem, with Germany.

Lord Kerr of Kinlochard: I am less impressed by the report which you have kindly shown us. I am not clear how you can be in a position to make statements like the one on page 33 where you say that the “Dubai route” is exclusively a phenomenon in the United Kingdom. If you have not had working co-operation with the United Kingdom I am not sure how you can state that the Dubai route is exclusively a problem in the United Kingdom. I take that as an example. I see that you basically decide on the scale of carousel fraud in Member States by making an assumption based on proportions of GDP per Member State, and I see that curiously you put the United Kingdom top of the list followed by France, Spain and then Sweden. I am not clear about the basis for any of these statements. It seems to me that it is very good to take an initiative against carousel fraud, but it is dangerous to make statements about the scale of carousel fraud in the United Kingdom without any working link with the United Kingdom authorities, and dangerous to say the Dubai route saying is exclusive to the United Kingdom if you do not have complete coverage across the European Union.

Mr Volders: That is not our problem. It is a remark. Why? Because it is very hard. We say it is now only in the UK but now we must prove why we made this statement, and Mr Hulot can answer that.

Mr Hulot: It says that you have a big risk if your country is big and if your reimbursements are abnormal. That is what the figures are saying. It is only that the United Kingdom is a very big country and the reimbursements in proportion are very big. That is only what I am saying there.
**Q76 Chairman:** It is a statistical observation?

**Mr Hulot:** Yes, it is statistical and macro-economic. In the study there are two approaches, macro-economic and micro-economic.

**Q77 Lord Kerr of Kinlochard:** Forgive me. Your league-table covers a minority of Member States, not including the largest nor several of the smallest. Cyprus and Malta are not there. Nor is Germany. An EU league-table without Germany is a very odd table.

**Mr Hulot:** It is because the data was not available for those countries. That was not published.

**Q78 Lord Kerr of Kinlochard:** That illustrates my point, if I may say so. I think it is very good to take an initiative, but very dangerous to publish conclusions drawn on the basis of only partial completion of the initiative.

**Mr Hulot:** My sources are the World Trade International, an international organisation. I only copied that data in the report. It was very indicative of the size of the country and the level of fraud.

**Q79 Lord Kerr of Kinlochard:** Why is the United Kingdom discussed throughout this report, although you say there was no co-operation with the United Kingdom, and Germany not discussed anywhere in the report, although you also say there was no co-operation with Germany?

**Mr Volders:** He has not found the figures for Germany.

**Mr Hulot:** They are not available. They are classified “confidential” in Germany.

**Mr Volders:** When we averaged the figures the representative end was bigger but we stayed with the macro-economic analysis based on the figures in Eurocanet and based on the figures from the countries who have published their figures. I think we have a representative study.

**Q80 Chairman:** I would live to move us on because this study is new to us, I think we should take it away, have a good look and come back and ask you a few more questions on paper so that we can establish what we are doing. We now know the kind of basis on which you have been operating, which I find very helpful. I would like to move us on to ask you what is happening in the Belgian economy. We have a faint feeling that perhaps Missing Trader Fraud manifests itself differently in each country and we would very much like to know what you think is happening here and what steps you are taking to deal with it.

**Mr Volders:** The politics of the approach in tackling this sort of fraud?

**Q81 Lord Watson of Richmond:** Not just that. You made the point right at the beginning that we are not looking at the same patterns of fraud, that even from the research you have done the evidence is that it is done differently, there is not a European-wide fraud, so to speak, there is fraud taking place in different Member States and it is done differently.

**Mr Hulot:** Yes.

**Q82 Lord Watson of Richmond:** How about Belgium?

**Mr Hulot:** In my team we identified eight typologies of fraud. We have to establish the difference between operators first, the fraud and the damage. Of course the problem is everywhere in the EU but the missing trader is in the UK and the damage is where the missing trader is. It is very important to identify which operators are in your country. In Belgium five years ago we had a very big problem with missing traders and the fraud was reduced by 10 in five years. We reduced the damage of that fraud by 10 times.

**Mr Volders:** We have the figures for that also.

**Mr Hulot:** Now we have conduit companies we have no fraud in Belgium but we have offshore companies for fraud in other countries and we have tried to fight against those companies. It is more and more difficult because there is no fiscal fraud in our country.

**Q83 Chairman:** Can I get it straight that your missing traders are now in other countries, is that right, they are not in Belgium any more, you believe them to be in other countries?

**Mr Hulot:** I work in the Police Service also and we know that all Belgian fraudsters are now in France, Spain or the UK.

**Q84 Chairman:** In England?

**Mr Hulot:** Yes.

**Q85 Lord Watson of Richmond:** There is one less now!

**Mr Hulot:** Yes.

**Q86 Chairman:** You got rid of them on the whole, you persuaded them to move, by enforcement.

**Mr Volders:** We have very stringent policies for attacking fiscal fraud. We had a commissioner of government in 2001 and now we have a secretary of state, the Minister of Finance, to attack fiscal fraud. Why has Belgium had experience in VAT fraud? Because we have had this system of the Benelux reverse system.

**Mr Hulot:** In 1993 and before in the 1980s.

**Mr Volders:** I think in the 1970s we had the reverse charge system between Belgium, the Netherlands and Luxembourg. We detected the carousel fraud in the 1980s.
Lord Cobbold: Do you think that the reverse charge could be applied throughout the Community?

Lord Watson of Richmond: Is it the most effective method of stopping this?

Q87 Lord Cobbold: Would it stop it generally?

Mr Volders: It is a political opinion now, it is not Mr Hulot’s opinion, it is a political opinion of the Director. With the reverse charge, the system that now exists, there are risks. We now have eight typologies already detected. When you have Kovacs doctrine, he has another statement and he wants another method of attacking fraud, another technique on the VAT system, but the change has got to be more at the last person in the chain logistically in the chain of goods. There are always risks in every system of your fiscal regime and there are possibilities for fraud. When you think about it, it is unbelievable that OLAF and the European organisations are not dealing with the Member States enough to deal with this international fraud because when you want to attack carousel fraud you must co-operate with the other countries. In the European Commission there is an institution for attacking fraud. Now it is a bilateral reunion but maybe we have to deal with the other countries also and ask whether you are experiencing it. We do not have an instrument where we can say, “Okay, this is the experience of Belgium, this is the experience of the UK”, then we could have it all in OLAF and maybe we would find more typologies than the eight because the missing traders are now in another country.

Q88 Chairman: It seems to me that the missing traders are offshore to the EU, which is the problem I am struggling with, that the missing trader on the whole has moved outside the EU countries, or is this not your experience, Mr Hulot, do you think they are still in the EU countries?

Mr Hulot: It is the companies which are moving out. The missing trader is where you have the damage.

Q89 Lord Cobbold: They have to be within the Union to benefit from the VAT.

Mr Hulot: Yes.

Chairman: Yes, that is true.

Q90 Lord Watson of Richmond: I have, if I may, a question which comes from your summary here. On the second page, you say: “... it’s of the utmost importance to gain intelligence and experience that should be shared in due time by all Member States. By making the best use of current European legislation, allowing the direct contact between nominated anti-fraud staffs, it must be possible to exchange faster and better intelligence.” If I understand correctly what you have been saying, even by making the best use of current European legislation, the fact is that you are not able to draw information from very important Member States, including the UK and Germany, I would like you to be more specific about the position of current European legislation. Are you saying that for this effort against fraud to become a comprehensive one you need new European legislation or are you saying that there is enough legislation there for you to widen your search to be comprehensive?

Mr Hulot: I think we have enough but it is another way of working. The Eurocanet project is legal, we have the 1798 regulation from 2003 and it is enough to work like this. We need another way to work together which is more flexible because VAT fraud is a very big fraud where you need to be very fast. The ordinary tools to fight against normal fraud are different. If it is for criminals I think we have the tools but it is the mentality that we have to change.

Lord Watson of Richmond: If I may come back to Lord Kerr’s point which really is fundamental. Unless and until you have comprehensive information it is not possible to answer the very first question which we posed, which is what is the scale of the problem, and if you cannot answer the question what is the scale of the problem you cannot either answer the question what is the severity of the problem. What is unfortunate about the way all this has developed through the BBC and all the rest of it is that what has actually come through is that there is somehow a special UK problem, which may or may not now be being properly addressed, it probably is. I come back to the original point. Is that really the picture that we should be looking or should we be looking at a much wider picture of this fraud across the European Union, in which case it is essential that you have the co-operation of Germany and the United Kingdom otherwise you will not be able to do this work.

Chairman: Nobody will be able to do this work.

Q91 Lord Watson of Richmond: Do you see the reason for our unease? In terms of a parliamentary report, as things stand at the moment we would simply have to report that the view in Brussels was that this is primarily a British problem. We will talk to people in Britain who will say that they have now tackled it and significantly reduced it, and you were saying that yourself, in which case there is no problem, it has gone away, but we could be making a very fundamental mistake and we may be looking at a much wider problem, much more diffuse within the EU and it may be growing rather than diminishing. I think we have to get this right. What you said initially would indicate to me that we should not spend too much time on this problem because it is actually diminishing, the UK has probably got on top of it and there is not much to talk about, but could we
The Guardian is immediate. We have can be very, very quick and the loss for the treasury Because damage for Europe and the Member States fraud is a very big problem for all the countries. Why? within the European Union. VAT fraud and carousel

Mr Volders: actually something much bigger?

Mr Rudy Volders and Mr Yannic Hulot

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making a bad mistake and what we are looking at is actually something much bigger?

Mr Volders: I think it is a problem for all the countries within the European Union. VAT fraud and carousel fraud is a very big problem for all the countries. Why? Because damage for Europe and the Member States can be very, very quick and the loss for the treasury is immediate. We have The Guardian and The Guardian has begun to give us shivers and we have been interviewed by the Belgian Parliament and the Secretary of State says “Okay, fiscal VAT Fraud is estimated at that”, and The Guardian has said, “In the UK this is the amount of VAT fraud”, and what they have they done is on the basis of the gross national product extrapolated from the other countries. The Belgian parliamentarians have read it in The Guardian and said, “That is strange. Secretary of State, why do you say the amount is that and The Guardian says it is very, very much bigger?” That is why the specialised people in VAT fraud have begun this work because when we know exactly the size of the VAT fraud you can come up with solutions. When you know how much is fraud it is a statistic, it is proof.

Q92 Lord Kerr of Kinlochard: I understand that but I do think it is dangerous on the basis of extrapolations to make statements about other countries’ problems. The total level that is discussed in your report is an extrapolation.

Mr Volders: Yes.

Q93 Lord Kerr of Kinlochard: The amount in the UK asserted in your report is an extrapolation. The breakdown between the—

Mr Hulot: The study is an extrapolation.

Q94 Lord Kerr of Kinlochard: It is an estimate. On page 37 you tell the world that in the United Kingdom 30 per cent of the problem is classic carousel fraud and 70 per cent is the Dubai route. On page 39 you say that the Dubai route is an important problem which must be given considerable attention in view of the “astronomical” amounts at issue for the United Kingdom. Forgive me, but publishing words like “astronomical” or numbers like “70 per cent”, or even giving an estimated total for somebody else’s problem, without discussing it with the person whose problem it is, seems to me to be very dangerous. I go back to what I said first. I think it is very good to take an initiative against carousel fraud but very dangerous to publish extrapolations on the scale of the problem in other Member States without using data from the other Member States. I cannot see what use we can make in our study of your extrapolations.

Mr Volders: I am a scientist, I work only on figures and perhaps for the public consideration it was a response to—

Mr Hulot: The Secretary of State is responsible and he has done his work, we have this report. The Secretary of State has said to the journalists that on the basis of our report we estimate the frauds to be like this. Maybe that is dangerous. We do not want a diplomatic incident, we want to co-operate. I hope the feeling of the people around the table is that it is a beginning.

Q95 Chairman: And a most useful thought.

Mr Hulot: We have to try to estimate the size.

Chairman: We have two more questions. Lord Cobbold has one and I have another one to ask people who are involved at this sort of technical one. Lord Cobbold.

Q96 Lord Cobbold: Do you feel that there is a role for OLAF in tackling this problem Europe-wide or do you feel it is best handled by the nation state at nation state level?

Mr Volders: It is best handled by the Member States because OLAF is not really competent.

Q97 Chairman: They have other jobs?

Mr Volders: We do not have the competence in OLAF that you have in the Member States. There are not so many people, there are only three for the VAT for all of the EU. The intervention of OLAF in the project at the beginning was only funding for the meeting. I have to say it was very important that at the beginning the project was not only involving Belgium but five countries, and among the five countries we had the UK. At the beginning we had very good contact with someone who was the boss from the CCT.

Mr Hulot: He has retired.

Q98 Chairman: I am not going to try and guess what happened. What I would like to ask, Mr Hulot, while you are here is there has been much talk about and, indeed, we have proposed a reverse charge on two commodities. You have views on whether reverse charging will fix the problem, whether it be ours or the European problem.

Mr Hulot: Yes, when we had the big problem of Dubai the reverse charging system was a good solution but at the moment it is over. For us we will have a new method very soon that we are looking at in the Eurocanet project so we will be able to say one week later if you have a new Dubai route or Hong Kong route—

Q99 Chairman: One assumes that somebody will find a new one.
Mr Hulot: It was a very big problem that some countries had but now you can have 100 carousels from one million pounds but with the reverse charge you can have one million fraud from £1,000. Do you understand?

Q100 Chairman: Not quite, except that both systems are subject to fraud because you have tried it.
Mr Hulot: With the reverse charge the fraud will be at the retail side.
Mr Volders: At the end.

Q101 Chairman: You are moving the fraud around?
Mr Volders: The risk is moving to the retailer.
Mr Hulot: With carousel fraud you have a small group which specialises in this fraud but with the reverse charge you have many, many fraudulent companies. It is impossible to handle it. If you have a big problem, after you have a very big problem, it is very difficult to comprehend.

Lord Cobbold: Does this mean that we need a complete rehash of the VAT system?
Chairman: Go to an origin system.

Q102 Lord Cobbold: Sales tax or whatever.
Mr Hulot: No, because you have other typologies, for example the definitive regime. It is very dangerous. In your company you have one invoice from Bulgaria and you have to say in one or two weeks if you can make the reimbursement. If you try to have contact with Bulgaria it is impossible to read what you have on the invoice, it is another alphabet, and you have to contact the anti-fraud unit in Bulgaria and ask, “Is it possible that you have £1 million on this invoice” and you have to answer within 10 days, which is impossible with the system of international co-operation now.

Q103 Lord Kerr of Kinlochard: You would not favour a move to an origin system because of the difficulty of trusting?
Mr Hulot: At this stage of international co-operation it is impossible. You have to reinforce the possibilities of direct exchanges and control and so on.

Q104 Lord Watson of Richmond: You were talking about the difficulty of getting responses from Germany and the United Kingdom. In terms of the new Member States—Bulgaria and Romania—have you established contact with them or not?
Mr Hulot: Yes, we did immediately. In the last quarter of last year they contacted us and asked us to visit and in February we will go to Bucharest and Sofia to make them—

Q105 Lord Watson of Richmond: That is reassuring.
Mr Volders: It was also the politics to co-operate. These new Members must immediately co-operate. I have visited Lithuania and their exchange programmes for information are performing better than the Belgians.
Mr Hulot: There will be members from the network at this moment.
Mr Volders: They have invested in new ICT, so they are the best performing machines.

Q106 Lord Watson of Richmond: That is the most reassuring thing I have heard this morning.
Mr Hulot: It means that by now they will receive all suspect transactions in the direction of their country from all the other Member States.

Q107 Chairman: I am personally most grateful for your help on the technical side because it has managed to knock on the head one or two ideas we were nursing about the technicalities of dealing with fraud. I have deliberately not sought to seek answers from either of you on the purely political questions because had Mr Jamar been here it would have been proper to ask him, but it is not quite proper to put those to you. We are meeting Eurostat at 11.30 so I am afraid we probably need to despair of Mr Jamar but, on the other hand, perhaps we might correspond with him.
Mr Hulot: No problem at all.
Lord Watson of Richmond: And with you, Mr Hulot.

Q108 Chairman: This technical information is most useful. We are very grateful for both of these reports which we had not seen. We can ask more questions, if we may, in writing.
Mr Hulot: You can ask more questions at the technical level and also at the political level.
Chairman: The technical level is extremely helpful.

Q109 Lord Watson of Richmond: You are aware that the European Parliament is also now going to carry out an investigation into carousel fraud.
Mr Hulot: The Economic Committee.

Q110 Chairman: I would still like to talk to the technical practitioners.
Mr Volders: Just as an example, we had an amazing VAT fraud in mineral oils beginning in 2000 and what did we do? We co-operated with the economic enterprises and there are two federations of petrol oil in Belgium and the Netherlands. All of the petrol oil comes from Rotterdam and is sent to Belgium. We have done a protocol between the two organisations, the two countries, to give all information when there is a tanker that is leaving Rotterdam, the Belgian authority is informed and vice versa, reciprocity. There are now no mineral oil frauds because we know everything. That ship must arrive there and if it does not arrive we have a problem. We have not detected another construction of VAT fraud in the mineral oil area with this simple agreement between two
federations. When I say it was €300 million in 2000 and we have estimated that because of the detection of fraud we have eliminated it to zero and we can say there is now €300 million in the Treasury for Belgium.

Q111 Chairman: Some number.
Mr Volders: That was just with this agreement. This was what Mr Hulot said also. All the Directives and Regulations for the exchange of information are already implemented but we must do it.

Q112 Chairman: That is a useful answer.
Mr Volders: How can we do it, we have a contact point like we have with Mr Simon Felderman, and now you have a contact point with Mr Hulot. That is the only thing, we must know each other and have confidence in each other.
Chairman: That is entirely right.
Lord Watson of Richmond: That is something we could help to facilitate. I have given you one name from that newspaper report from the Revenue service.
Chairman: Thank you very much indeed.
STOPPING THE CAROUSEL: MISSING TRADER FRAUD IN THE EU: EVIDENCE

WEDNESDAY 10 JANUARY 2007

Present Cobbold, L
Cohen of Pimlico, B (Chairman)
Kerr of Kinlochard, L
Watson of Richmond, L

Memorandum by Commissioner Kovács, Commissioner for Taxation and Customs Union,
European Commission

WHAT IS THE EXACT NATURE OF VAT CAROUSEL FRAUD?

1. On domestic supplies, a supplier charges VAT to his customer. His supplier pays this VAT to the Treasury. A business customer can reclaim this VAT from the Treasury. It is the final consumer who bears the VAT charge since he can not reclaim the VAT from the Treasury.

2. However, the rules are different for supplies to business clients in other Member States. In this case the supplier does not charge VAT and the goods circulate VAT free.

3. The missing trader fraud in intra-community trade (the so-called “MTIC fraud or carousel fraud”) works as follows.

4. A company (B) acquires goods in another Member State without having to pay VAT to his supplier (A). Subsequently it makes a domestic supply for which it charges VAT to his customer (C). However, the company (B) does not pay the VAT to the Treasury and disappears. The customer (C) claims a refund of the VAT paid to the company (B). Consequently, the financial loss is for the Treasury which has to refund VAT to the customer (C) which it never collected from the supplier (B).

5. Subsequently, Company C may declare an exempt intra-community supply to Company (A) and, in its turn, (A) may make an exempt intra-community supply to (B) and the fraud pattern resumes, thus explaining the term “Carousel fraud”.

6. The main elements are the fact that has been an intra-Community acquisition and a trader charging VAT to his customer but not paying it to the Treasury and “going missing”.

7. This is a very simplistic description of the fraud, which in reality is much more complex, involving a series of transactions with intermediary companies (D) in order to hide the fraudulent character of it.

ARE THERE GAPS IN LEGISLATION WHICH ALLOW THIS FORM OF FRAUD?

8. The abolition of fiscal controls at the time of implementation of the internal market (1993) has been of an enormous benefit for European businesses. The free circulation of goods within the Community has considerably reduced the administrative burden and costs related to intra-community activities.

9. Nevertheless, the way the current European VAT arrangements are designed are that intra-Community supplies of goods between taxable persons established in different Member States are exempt in the Member State of origin of the goods, with taxation taking place in the Member State of destination. In order to allow this system to operate, without frontier controls, a system of automatic exchange of information specific to intra-Community transactions was installed (the VAT Information Exchange System or VIES). This information is exchanged between Member States three months after the end of the quarter during which the transactions took place.

10. The exchange of information via VIES provides useful information to the fiscal authorities but is as such not a totally adequate instrument for combating carousel fraud, for which a quick intervention is crucial.

WHAT IMPACT DOES THIS FRAUD HAVE ON THE INTERNAL MARKET?

11. Although only a few Member States have made estimates of carousel fraud available, it is obvious that the problem is of worrying Proportions.

12. MTIC fraud deprives the State from considerable income that should be used for the implementation of public services at national level.
13. MTIC fraud also undermines the competitiveness of legitimate traders. This is certainly the case in some specific sectors which are most affected by MTIC fraud, like computer parts and mobile phones sectors.

14. Goods which have been used for MTIC fraud will end up on the market at a price which is lower than normal (since the real benefit for the fraudsters consists of the evaded VAT). As a consequence, fair competition is no longer guaranteed in these sectors.

**WHAT ARE THE MEASURES CURRENTLY APPLIED TO COMBAT THIS FRAUD AND WHAT ARE THEIR WEAKNESSES?**

15. The organisation of tax administrations and the definition of their strategy for control, including specific operational measures against MTIC fraud, fall within the competence and responsibility of the Member States.

16. The Commission's role is to ensure a more common and co-ordinated approach between Member States in the fight against tax fraud. It is indeed clear that the free circulation of goods and services within the internal market but also the globalisation of trade makes it practically impossible for a Member State to act individually against tax fraud.

17. Within this context, the Commission firstly has to ensure that an appropriate legal framework is available at Community level for efficient administrative cooperation between Member States. The Commission, with its right of initiative, has to propose new rules when necessary but it is up to the Council to adopt them.

18. Secondly, the Commission coordinates a lot of work at an administrative level. It organises, at regular intervals, meetings and seminars bringing experts of the Member States together in order to share their experiences and best practices. This work has contributed significantly to reinforce Member States’ fight against MTIC fraud and to improve their control strategies.

19. Today Member States have a solid legal instrument for administrative cooperation at their disposal, providing the possibilities for a quick and efficient cooperation between Member States. In practice, however, Member States do not fully exploit the possibilities offered by these arrangements. In particular, the level of exchange of information between member States is not proportionate to the level of intra-community trade. Thus whilst fraudsters take advantage of the existence of the single market without internal border controls, national tax administrations still act predominantly within a national context.

20. The Commission is of the opinion that the fact that the existing administrative cooperation arrangements are not used to their full extent is a major weakness in the fight against MTIC fraud.

21. Finally, individual Member States can, on the basis of Article 27 of the Sixth VAT Directive, be authorised by the Council to introduce special measures to derogate from the harmonised VAT rules in order to prevent certain types of tax evasion or avoidance. In this way, specific problems in certain Member States can be addressed in a relatively quick way, but each derogation implicitly marks a deviation from the overall objective of a common VAT system in the Internal Market. Therefore, individual derogations are not a sustainable solution in the long-term.

**ARE THE MECHANISMS SUGGESTED BY THE COMMISSION TO FIGHT THIS FRAUD ADEQUATE?**

22. As explained above, it is the competence and responsibility of the Member States to set up and implement an action programme against MTIC fraud.

23. However, it is the Commission’s view that combating MTIC fraud, which takes advantage of the benefits of an internal market without border controls, requires efficient cross-border cooperation between tax administrations. Strong and rapid cooperation between Member States should be a key element in the strategy developed at national level against MTIC fraud.

24. Considering the importance of tax fraud, the Commission presented in May 2006 a Communication concerning the need to develop a co-ordinated strategy to improve the fight against fiscal fraud.

25. The objective of the communication is to launch a wide debate with all stakeholders involved on a whole range of pragmatic and realistic ideas that could be taken in the short term and that will contribute to the improvement of the current situation. However, since the protection of tax revenues is a major aim of this communication, it is clear that Member States are the first concerned.

26. A first package of measures aims at improving and reinforcing administrative cooperation between Member States. Today, we are still missing a real Community administrative culture and in order to remedy it, there is a need for a strong political commitment from Member States. In this context new instruments such as databases where basic information is accessible to all tax administrations are needed.
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27. However, fiscal fraud does not stop at the external border of the European Union. It is therefore becoming increasingly important to develop the external aspects of administrative cooperation. Today cooperation with third countries takes place primarily under bilateral agreements. This approach does not ensure the necessary effectiveness and it is time to examine a move towards a more coordinated approach at Community level.

28. The Communication also opens the debate on the need to modify the Common VAT system, an issue that the Commission is prepared to consider. Extending the use of the reverse charge or taxing intra-Community supplies are possible options in this respect.

29. It should be noted, however, that the Commission is not suggesting in its communication one single and global solution to the problem. Instead, it presents a number of ideas for debate and hopes for a quick, positive and clear response from the Member States through the Council that will enable it to rapidly present an effective anti-fraud strategy insisting on the complementary aspects of national and Community actions to be developed.

ARE MEMBER STATES, WITHIN THE CONTEXT OF THE INTERNAL MARKET AND THE GLOBALISED ECONOMY, CAPABLE OF FIGHTING INDIVIDUALLY AGAINST THIS FRAUD OR IS IT RIGHT FOR THE COMMISSION TO BRING FORWARD PROPOSALS ON THEIR BEHALF?

30. Tax fraud is a global phenomenon. Fraudsters are ahead of many companies and of tax administrations in terms of globalisation. In the context of the internal market, in particular, fraudsters take advantage of the four freedoms to move their activities very rapidly in order to escape from the reach of tax administrations that remain organised at a national level.

31. This context makes it practically impossible for a Member State to act individually against tax fraud.

32. It is therefore the role of the Commission to stimulate a debate on a co-ordinated approach. The objective of a co-ordinated approach is to increase the efficiency of the efforts to be taken at national level against MTIC fraud.

DOES THE ADOPTION OF MEASURES TO FIGHT VAT FRAUD AT COMMUNITY LEVEL UNDERMINE MEMBER STATES’ CONTROL OVER THE FUNCTIONING OF NATIONAL FISCAL SYSTEMS?

33. As already indicated before, the operation of the tax systems is and should remain the competence of Member States. The organisation of the tax administrations and defining their strategy for control are of the competence and responsibility of the Member States.

34. By presenting the Communication, it was certainly not the Commission’s intention to intervene in the competences of the Member States. A co-ordinated approach at EU level should provide to the Member States more efficient tools to ensure the proper functioning of their national fiscal systems.

9 October 2006

Examination of Witnesses

Witnesses: COMMISSIONER KOVACS, Commissioner for Taxation and Customs Union, and MR STEPHEN BILL, Head of Cabinet, European Commission, examined

Q113 Chairman: Good morning, Commissioner Kovacs.
Mr Kovacs: Welcome to the Berlaymont, the headquarters of the European Commission. I understand that Stephen Bill, who is the head of my Cabinet, has already discouraged you from asking very, very technical questions. In general terms Commissioners are politicians who are dealing with the political direction of the portfolio concerned, so I am dealing with the priorities of tax policy and also the Customs Union. My philosophy is to improve with tax measures, with the reform of the tax system, the work or the functioning of the internal market, the Single Market. That is my point of departure because I do believe competitiveness is one of the major aims we have to achieve as the global competition is the first in the row of the global challenges the European Union and the Community are facing. Competitiveness is extremely important. We are very proud of the Single Market and I very often refer to the fact that when I was twice the Foreign Minister of Hungary, my country, and I argued for the accession of Hungary to the European Union I always referred to the Single Market as one of the major achievements. At that time it had less than 400 million consumers and now it has nearly 500 million consumers, half a billion, after the accession of Romania and Bulgaria. It is quite obvious that...
from the point of view of competitiveness, to work and do business in such a huge market, a competitive Single Market, it is a great advantage, a great asset. When I started my current work, which was completely new for me because I had never been a tax professional, I spent most of my life in foreign politics, I realised there were so many tax induced barriers to the Single Market which came from the fact that there were 25, now 27, different tax systems working in parallel. That results in an enormous sum of compliance costs, administrative burdens, sometimes a lack of transparency, and all of those are somehow barriers to the internal market, the Single Market. That is my background. Today I was reading the questions and I said to my Head of Cabinet it is not my level, it is mostly at his level, who spent some 20 or 30 years in the Tax Directorate General—

Mr Bill: Twenty.

Mr Kovacs:—or the prominent experts of DG Tax who have been dealing with these issues for some 20 or 30 years. I agreed with Steve that to make this opportunity useful for you I would make a general statement on the political priorities as far as tax fraud is concerned and as far as the technical details, the concrete questions, are concerned Steve and maybe I will try to answer them.

Q114 Chairman: That would be very useful. Mr Kovacs: Is that acceptable for you?

Q115 Chairman: It would be very useful to know where the political priorities are, where we have got to and what happens next.

Mr Kovacs: Good. First of all, I have to underline that tax fraud is a very serious concern for the Community as a whole and, consequently, for the Commission. At a Community level the estimated annual loss that we suffer is between €200 billion and €250 billion. Bearing in mind that we spend €50 billion a year for the Common Agricultural Policy, which is also a major concern for a number of countries, it is quite understandable that losing such an enormous sum of money which we could spend on social programmes, on education, public health, on a number of other issues, is an evil which we have to combat. That is the point of departure. The question is how can we do that because the Member States have been combating tax fraud for quite a long time without any major success. The estimated sum of money which we are losing is increasing. Last June the Commission tabled a communication to the ECOFIN Council of Ministers of Finance in which the Commission outlined certain options. It was the first step in developing a common strategy because it was obvious that Member States are not able to successfully combat tax fraud on an individual basis. Last June we tabled this communication and the first option which was proposed in the document was to improve the traditional instruments and use them more extensively. First of all to improve the national control in the Member States and, second, to speed up the exchange of information because that is one of the weak points of the current system, that the VAT Information Exchange System goes very, very slowly, it takes two or three months sometimes to exchange information. I can also mention the very small proportion of information which has been exchanged in comparison with the number of traders. There are some 35 million traders who are involved in intra-Community trade and are involved in billions of transactions, while in 2005, which is the last year for which we have statistics, there were 26,000 information exchanges, a very small number in comparison with the billions of transactions and millions of traders. The Commission concluded that one option could be to improve these traditional methods, to speed up the exchange of information, to make them more extensive. The second option was to change the VAT legislation which is certainly more complicated. You know that we need unanimity on all major tax policy issues and after the two years I have been in office I have learned how difficult it is, not on such complicated issues but on much more simple issues like, for instance, the application of reduced rates on labour intensive services which we wanted to solve during the UK Presidency and failed, then we continued during the Austrian Presidency and finally succeeded but the discussions we had were a nightmare, particularly with some Member States who were very reluctant to agree. Quite recently, when we wanted to revalorise the Minimum Excise Duty rate on alcohol and alcoholic beverages with different compromise solutions, we had reached a point where 24 of the 25 Member States agreed but then the Czech Republic said no. That was difficult to understand because the current level that applies in the Czech Republic is higher than the suggested increase in the Minimum Excise Duty rate, so the increase would not have been reflected in the price of beer in the Czech Republic. For them it was a matter of principle that as there is no positive Excise Duty rate on wine they were not prepared to accept an increase in the minimum rate on beer. We explained to them that the current system was approved in the early 1990s and, whether we find it fair or not, in order to change it, to introduce some positive rate on wine for instance, it would need unanimity. Bearing in mind there are more than 10 countries that are super-powers in wine producing and wine consumption there was no chance to introduce a positive rate. I think the advantage of these traditional methods to improve national control, to improve the exchange of information, is they would be easy. It would be easy to reach unanimity because there is nothing new in that. The second option to
change the VAT legislation is much more difficult because option 2a would be to apply the origin system, not in the original form but in a modified form. In the original form it would mean the goods would be taxed in the country of origin and at the rate applicable in that country which would be impossible to apply because that would need much deeper harmonisation of the VAT rates, which is impossible because most of the Member States consider setting the VAT rate as a basic question of tax sovereignty. What we could do is have a modified version of the origin system to tax the goods in the country of destination at the VAT rate applicable there. Even this would be a very long ride to achieve. Option 2b would be the reverse charge model which is championed mostly by Germany and Austria and, as I understand, in the UK there is sympathy for at least a limited scope of use of the reverse charge model to apply it in the framework of a derogation from the VAT Directive. Concerning the reverse charge model, the problem is that there are many Member States that have very serious concerns because they claim that the reverse charge model may be applied successfully against the carousel fraud, VAT fraud, but may open the door for some other kinds of tax fraud. The current situation is that if we put it on the agenda of an ECOFIN meeting there will be more than one country that would say no. Yesterday when we were in Berlin we had the traditional meeting between the government of the incoming Presidency and the Commission, and we had the plenary with Angela Merkel and President Barroso. We also had bilateral meetings between the Commissioners and members of the German Government who are responsible for the various portfolios and I had the chance to meet and exchange views with Minister Steinbruck, the Minister of Finance in Germany. We finally agreed that in the April informal ECOFIN meeting we will put it on the agenda or, to be more precise, we will not put it on the agenda but on the menu card at the lunch of the informal ECOFIN to discuss it in the framework of a first reading to try to find out the reaction of the Member States. At the moment we have not discussed it at the level of the ministers. It is my experience that even if you discuss something 100 times at the expert level, the picture can be very different at the level of the ministers because they have some political considerations which the experts could not and should not have. We agreed that will be the first test, what the reaction will be to this proposal of the reverse charge model, and then we will see how to proceed. Minister Steinbruck was rather optimistic because they are very interested in introducing this system and they want to introduce it as an option, that if a Member State wants to apply it it should be allowed to do it on an optional basis. The problem is that would somehow go against the logic of the whole VAT system which is universal because in that case it would be much more fragmented. Minister Steinbruck expressed his hope that if there is a positive reaction in April then in June when we have the last formal ECOFIN meeting during the German Presidency, the April informal meeting will pave the way for a concrete decision, which I do not believe, I think it will be too early. Maybe in June we will have a clearer picture but nothing more than that. That is the case as far as the anti-tax fraud strategy is concerned. That is the political framework from my view.

Q116 Chairman: Thank you very much indeed, Commissioner Kovacs, that is most helpful. We have a number of questions and different people will ask different bits but, please, either you or Mr Bill answer whichever suits you best. The one I would like to pick up out of your statement—there is much in your statement I would like to pick up—is we are having some trouble with figures because we have some figures for carousel fraud, which is what we are actually looking at. Your figure of €200 billion to €250 billion is an all-fraud figure, is it, fraud of any sort?

Mr Kovacs: It is all fraud, all tax fraud at a Community level.

Q117 Chairman: It is an extrapolated figure because you cannot really survey fraud.

Mr Kovacs: Yes. You cannot estimate precisely the amount of fraud, you can make some estimates. The figures you have are either on the carousel fraud specifically and at the UK level which should be around €6 billion or £7 billion, if I am right.

Q118 Chairman: We owned up in the Autumn Statement to some figure between £3.7 billion and £4.5 billion. I do not doubt that there is an update on that. Within that global figure of €200 billion to €250 billion, has any estimate been made by your committee on how much of that might be carousel fraud, or have you not done that?

Mr Kovacs: The reason why we do not have any more precise figures is very, very few countries publish any figures. The UK is one of the exceptions, and Germany is the other one, but I do not think there are more than three or four countries that publish figures.

Mr Bill: The German figures are more global than the UK figures where the UK tries to break it down into the different sources of losses. What we have tried to do is to extrapolate from the few Member State figures that we have, taking into account the relevant turnovers of different Member States, to see what the order of overall fraud could be across the Community.
Q119 Chairman: This is all sorts of fraud, income tax fraud, any fraud?  
Mr Bill: Yes, but it is an art more than a science.  
Chairman: I am sure. Thank you.

Q120 Lord Watson of Richmond: Because this is such an enormous and dramatic figure, if I could just ask one other question on it. Are you saying, therefore, that if you take the totality of fraud within the area of the European Union, the states of the European Union are being cheated, so to speak, of €250 billion? It is not the institutions, it is the Member States themselves.  
Mr Kovacs: Yes.

Q121 Lord Watson of Richmond: So when you say think of what else this money could be spent on, schools, hospitals and so on, it is what the Member States would have available to spend if this fraud could be stopped.  
Mr Kovacs: Absolutely. When I used the plural I meant the Community as a whole but certainly not the European Commission or the Council.

Q122 Lord Kerr of Kinlochard: There is no excuse for fraud, clearly. But to the extent that these frauds exist inside a Member State and do not have a cross-border dimension they are a function of a judgment by a Member State about how heavy its indirect tax regime should be. I am not trying to excuse the fraudster, but it is reasonable for a Member State to make that judgment. One may think they are being a bit soft but it is for them to say, is it not?  
Mr Bill: I think what you are saying, in effect, is that you never collect 100 per cent of any tax and, therefore, what we are saying is, “This is what more you would collect in an ideal world if you could collect 100 per cent”, but from what you are saying, if you turn it round the other way, if you had all the resources available and a relatively honest taxpayer base you could collect that amount of money, but it is clear that you are not going to. These figures are all sorts of tax losses which we extrapolate from the UK as well which is not just tax evasion, it is tax avoidance as well.

Q123 Lord Watson of Richmond: Just to come back to this big figure again, when after giving us that figure you asked two questions, think what it could be spent on if it was not lost, and your second question was what can we do about it. The answer to what can we do about it is a specifically EU answer. You talk about improving traditional instruments particularly for the exchange of information between Member States and you talk about the disparity between 20,000 exchanges of information and 35 million people trading across borders and then you talk about the VAT proposals. My question is this: the €250 billion figure is a total figure across all Member States but have you got any specific idea about what proportion of that figure is related actually to trans-border trade, in other words what proportion of that figure has an EU dimension to it?  
Mr Kovacs: As far as carousel fraud is concerned it is an EU dimension because—

Q124 Chairman: Indeed, that is the way it works.  
Mr Kovacs: It comes from the very nature of intra-Community trade. You cannot expect carousel fraud inside one Member State, it needs at least two Member States. Very often the fraud involves a third country, a non-EU member country, in order to disguise it from the authorities.

Q125 Lord Watson of Richmond: Is carousel fraud the only kind of fraud that has an EU dimension to it?  
Mr Bill: No. We cannot give you the answer to your question off the cuff but you could extrapolate it backwards. If you took the UK’s figures of the total VAT gap and saw what per centage of that relates to carousel fraud and then applied the same per centage to the €250 billion; under the sort of extrapolations that we have done that would give you the sort of answer you are looking for.

Q126 Lord Cobbold: Different countries have different trade priorities.  
Mr Bill: Yes, but we cannot factor that in because we do not know that from the different countries because most of them have not done the exercise.

Q127 Lord Kerr of Kinlochard: What do you think of the figures that Eurocanet have produced, or the Belgian Finance Ministry?  
Mr Bill: We have no knowledge of where those figures come from. We cannot justify them and we cannot substantiate them.

Q128 Lord Cobbold: Eurocanet is completely separate, has no relationship with the EU?  
Mr Bill: No relationship with the Commission whatsoever.  
Mr Kovacs: To be frank with you, I am not so concerned about the exact figures because even if it is not €200 billion, just €100 billion, that is more than enough. I am much more concerned how to tackle this issue and in what way we can combat it successfully. That is my concern. I will tell you that I use these figures simply to shock the audience because I want them to understand that it is a very serious issue, a huge loss of money which Member States could spend on much better purposes. In order to involve them, to motivate them, I use these figures. Even if it is €100 billion or €300 billion, which is a much higher figure, it does not make much difference,
it is important that we have to combat it because we
Chairman: Thank you very much. We will give up on
the figures. We just wanted to ask because we saw
Eurocanet this morning and we only have estimates,
other people only have estimates, and I wondered if
there was a magic number anywhere. As you have all
made quite clear there is not, if I may I will turn our
attention to what you do about combating carousel
fraud.

Q129 Lord Cobbold: Where do your figures come
from if they do not come from Eurocanet? Is it just
information from Member States?
Mr Bill: They are an extrapolation of the figures that
are available to us from the limited number of
Member States who have made figures available to
us.

Q130 Lord Cobbold: Extrapolation is the key word?
Mr Bill: Extrapolation is the key word. I would
emphasise once again that it is an extrapolation of
global tax losses which includes avoidance,
bankruptcies, fraud.

Q131 Chairman: Some of which combine.
Mr Bill: Yes. It is difficult to distinguish. It is
impossible to distinguish.
Mr Kovacs: It is even more complicated than another
evil in the other half of my portfolio, which is fake
goods, counterfeiting. I am so lucky that I have one
evil in both parts of my portfolio! The estimated
figure is €500 billion of fake goods in circulation in
the market but, of course, that is also an estimation
because what we know are the transactions which the
customs officials finally catch.

Chairman: Lord Cobbold, perhaps you would like to
ask about ECOFIN.

Lord Cobbold: Do you support the United
Kingdom’s efforts in the request for a derogation
that the UK made to ECOFIN, which has been rejected
up until now although it is perhaps closer to being
agreed, and do you think it is something that the UK
is just doing to protect its own interests or is it
something that could be applied generally in helping
to eradicate this form of fraud?

Q132 Chairman: If I may expand that question a
little. In your statement you were disposed to wait to
consider reverse charging until later in the year but
the United Kingdom was looking for a very specific
derogation on two sets of goods. Do you, as it were,
consider that separately or are you trying to row it in
with the rest of the consideration?
Mr Kovacs: There were three requests for derogation
more or less at the same time: one from Germany,
another one from Austria and the third one from the
United Kingdom. The German and the Austrian
requests were rather similar in that they wanted to
apply the reverse charge model on a general basis
which was beyond the scope of derogations permitted
under the VAT Directive so the Commission refused
their request. The UK request was different because
the scope was limited, it was much better targeted
because there were only two kinds of products on
which the UK wanted to get this derogation,
computer chips and mobile phones, so these two
articles, and we said yes. Considering that we said
yes, the Germans and Austrians were not very happy
that we said no to them and yes to the United
Kingdom. It was France at ECOFIN that finally
objected. I do not know whether there are any new
developments because I heard the French may have
softened their position, but I do not know.
Mr Bill: No. We understand the position is still
blocked in Council.

Q133 Chairman: They apparently softened their
position and then hardened it again.
Mr Bill: Apparently.

Q134 Chairman: I think “apparently” as well.
Mr Kovacs: It was not even officially brought to the
ECOFIN Council. It was not raised because the UK
delegation learned from the French through a
bilateral consultation that the French would raise a
veto, so they did not raise it. It was on the agenda but
it was not discussed because of this negative position
from France. I know the argument, not from the
French but from the UK delegation, was that the
French believe and argue that if the UK closes the
door on the fraudsters then they will go to France and
operate there. That was France’s argument. The
Commission suggested continuing the bilateral talks
and I offered to the UK if the Commission could be
of any help we are ready to intervene and we are now
in a wait and see attitude.

Q135 Lord Cobbold: That is the problem with
derogations, on an individual nation basis you are
always going to have other nations who object. How
do you move from A to B?
Mr Bill: It is very rare that a Member State objects to
an Article 27 derogation because by definition
an Article 27 derogation is very targeted and
proportional. It is our responsibility to ensure that
normally Article 27 derogations go through more or
less on the nod because they would have no effect on
any other country. By definition that is the scope of
Article 27. If it goes beyond that, and we have reasons
to fear that this may interfere with the functioning
of the internal market or be a big deviation from
the normal VAT system, we would not make a
recommendation, and that is why we did not make a
recommendation or proposal to the Council in
respect of the German and the Austrian requests

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because they went far beyond what we considered should be the scope of Article 27. After discussion with the UK authorities we considered that what the UK wanted was sufficiently narrow and sufficiently targeted that it fell within the scope of Article 27 and would not have any other effects. Of course, being a fiscal matter and the final decision having to be made in the Council, it is not the Commission that makes the final decision it is the Council by unanimity, and on this occasion our judgment call was not quite correct because not all Member States agreed with what we were saying that this was proportionate and would not have cross-border effects. At least one Member State felt that it goes beyond what could possibly be acceptable under Article 27.

Q136 Chairman: What do the UK, do now? Is it likely to go on or get swept up with the Germans and the Austrians who want something more far-reaching?

Mr Bill: Sorry, can I just finish the logic of what I was saying. What we said to the Germans and the Austrians, and what the Commissioner was talking about in his opening statement, was that if we want to satisfy the Germans and the Austrians, which is to enable Member States to have a derogation from the general VAT system to apply a reverse charge to a substantial amount of their internal turnover, this would require an amendment to the text of the main VAT Directive itself, not a derogation from the main rules but an amendment to the rules permitting those Member States, if they wish, so to derogate. That is what is under discussion now as to whether or not the Commission should make a proposal to permit Member States to make this derogation. The UK’s situation is still separate. It is still a specific request under Article 27. As the Commissioner said, this is now really in the hands of the UK and those Member States who need to be persuaded. It is still on the table of the Council and negotiations will continue. The answer to your question is you have to continue to try to negotiate and persuade those who are not convinced that this will not do them any harm.

Mr Kovacs: At this time there is only one country that is opposed and that is France, but it has happened during the two years I have been in office that once a Member State that opposes a concrete proposal is convinced or persuaded then next time it is another Member State that says no.

Chairman: I share your view. Lord Cobbold, do you want to ask about the general position on reverse charging?

Q137 Lord Cobbold: It follows from what I was asking earlier. How should we proceed? What is the solution to this problem? Is the reverse charging on a general basis the right way forward? You mentioned two options and I just wondered what your preference is.

Mr Kovacs: I could give a much more precise answer after the informal ECOFIN, the exchange at the informal ECOFIN, and the even more informal lunch when it will be discussed at the level of the ministers for the first time. The problem is that in the meeting room it has been only Germany and Austria, not even the UK, I do not think the UK intervened—

Mr Bill: No. The UK has come out against the generalised reverse charge supporting a specific and targeted one but it has not been supporting the generalised one.

Mr Kovacs: The other ministers kept silent. We do not really know. In the corridor they express their views and their concerns that this reverse charge model could have some other risk so we should be careful in saying yes to it. That was the reason why I encouraged Minister Steinbruck to put it on the agenda of the informal ECOFIN to have a clear picture, to go around the table. That was what we did with some other proposals during the Austrian Presidency, we somehow provoked the Member States to say yes or no and to express their views at the level of the ministers, not at the expert level. After this April exchange of views we will have a much clearer picture as to whether there is any chance because there will be no sense in tabling an official proposal of the Commission and having some 15 countries against it.

Mr Bill: I think it is true to say that certainly at Working Group level more Member States have expressed concern about the generalised reverse charge than a specific targeted derogation under Article 27, such as the UK is requesting. We do not know but one of the fears of the French and one or two others may be that the specific derogation that the UK is requesting may be the thin end of the wedge opening the door to further reverse charge derogations, including a generalised one, which they fear more. If you wanted an educated guess as to which you are more likely to get, I would say that you are much more likely to get a targeted derogation under Article 27 than a generalised reverse charge because there are far more Member States who have expressed concerns about the generalised reverse charge than they have about the specific one.

Q138 Chairman: Including us.

Mr Bill: Including yourselves, yes. The position you are in is probably the more sustainable one with a request under Article 27.

Q139 Lord Cobbold: So despite the variations it might get rid of a lot of the problem?

Mr Kovacs: No, because it does not get rid of the German and the Austrian problem because the German and Austrian—
Q140 Lord Cobbold: You cannot amend those. Mr Bill: They certainly cannot be accommodated under Article 27, it would require a full amendment of the Directive which would require us firstly to believe that it is right to make that proposal, and those discussions are still going on and we are investigating as to whether or not there are substantial cross-border effects, whether there would be concerns for the internal market if we made such a proposal, in which case we would have no justification for making it.

Mr Kovacs: It is clear that the ambitious solution would be to change the VAT legislation either in one way, the way of the reverse charge, or in the opposite way, the origin system, the modified origin system, but the more realistic solution would be to improve the traditional methods even though there is some speculation as to how to identify the invoices, for instance. For carousel fraud you need fake invoices. I have been approached by some experts who have suggested different kinds of methods to identify the invoices and I have requested them to put it in a paper and we can examine it carefully with the experts on tax, but that has not shown up, I am still expecting some answers to come.

Q141 Lord Kerr of Kinlochard: Can I pursue the second course? If one were to go for an origin system, as the Commission originally proposed (and it was wicked men like me in Coreper who defeated the Commission’s original proposals) this particular form of fraud, Missing Trader Fraud, would be eliminated, would it not?

Mr Kovacs: Yes.

Q142 Lord Kerr of Kinlochard: As I recall the arguments made by wicked men like me we were opposed principally because of the complexity of the clearing house arrangement. It seemed very elaborate and it would have created the possibility for other kinds of fraud or abuse. I think I have understood what you mean by a modified form at which the rate of VAT would be charged on the goods, but would you not still be left with the requirement for a clearing house?

Mr Bill: No. This gets rather technical. The idea that we have put on the table is designed to avoid the two traps which you fall into with the origin system. The origin system applies tax at the rate applicable in the country of origin and it is collected in the country of origin, but the money is never due to go to the country of origin because VAT is a tax on consumption and the goods are going to go to another country to be consumed. Therefore, the money has to be transferred to the country of consumption, that is why you need a clearing mechanism, and you have the problem that unless you approximate the tax rates then you will have lots of distortions in purchasing patterns and so forth. The idea that we have now come up with is to say that instead of using the tax rate and collecting the tax in the country of origin, you would use the tax rate and collect the tax in the country of destination. So the tax would not be collected in the country of origin, therefore you do not need a clearing mechanism and you would not have the pressures leading towards harmonisation of tax rates because you would still be retaining tax sovereignty. The tax rate which would be applicable and the tax which would be collected would be that of the country of consumption, so there would not be the same pressure. The problem that you do have, of course, is that you would then create a requirement for a lot more people to register in another country than where they are established because if they are just sending goods to another country they would then be liable for the tax in that other country at the rate applicable in that country. That is where we come to the solution which we did not have in the 1980s where we have the kernel of a solution. This is the proposal we have on the table now for a VAT one-stop-shop where you could register and account for all your liabilities in other Member States in your country of origin. So we would extend the idea of the VAT one-stop-shop so that a UK trader would be able to make all his tax declarations for all his liabilities in other Member States in the UK on-line in his own language and then he would make a single payment. He would do the clearing, if you like, he would pay to the country of consumption, so we do not have to have a clearing mechanism and we do not have the threat which the origin system posed.

Q143 Lord Kerr of Kinlochard: Thank you, that is very interesting. I did not understand your option 2b but I now do. However, it appears to be slightly academic because you, Commissioner, in your communication are clear that this is something to be considered but that action now should be in the area of improved co-operation, information exchange between Member States and so on, and I get the impression that the Member States agree with you about that and do not see the disruption of a move to the origin system, even this more sophisticated form of origin system, as being something to be undertaken in a hurry. It looks as if we are, at least for the foreseeable future, the next few years, stuck with the destination system and our efforts should be principally directed to improving information exchange and co-operation. Do I capture your view correctly?

Mr Kovacs: Absolutely. The problem is that it is not my view but the view of the Member States. It would be much easier to convince me to change the VAT legislation. The difference between the different models as I see it is improving the traditional
methods, the application of the traditional instruments, is not very innovative and is not particularly promising but it is easy to come to a common understanding and even unanimity. I think even at the June ECOFIN they would get unanimous support for that because these are the methods that have already been used by the Member States, they are nothing new. If we could find some good methods on the identification of the invoices, I do not think any Member State would oppose that. The problem is changing the VAT legislation, either in the direction of the origin system or in the direction of the reverse charge model, is more innovative but more risky and it would be far more difficult to reach unanimous agreement on either of those two.

Q144 Chairman: You said, I believe, however, that the proposal to crack the new origin system was on the table. If it is on the table, has it been received with any favour? Mr Bill: It is not a proposal, it is an idea.

Q145 Chairman: How is it going down here? Has it been received with any favour anywhere? Mr Bill: We have not yet had the full discussion on it. Mr Kovacs: We have the framework established by the Court, the idea of co-ordination of action. This means we sit down together with the Member States, the idea of co-ordination of action. This means we sit down together with the Member States and look at areas and say, “How is it going down here? Has it been received with any favour?”

Q146 Lord Cobbold: Would it be helpful if it was in our report? Mr Kovacs: What I am expecting from the April exchange of views is that the ministers will express their views and after that we can come together with the German Presidency and with the experts on tax and find some balance on what to do. If we see that there is some considerable support for changing the VAT system in either of the two directions, in that case we can start to elaborate it more precisely. If we see that there is a strong reluctance to change the VAT system, in that case we have to focus on the traditional matters and come to a final solution at the June ECOFIN.

Q147 Lord Kerr of Kinlochard: Can I ask about one area where I was not quite sure that I fully understood the communication? “Joint and several liability” would increase the number of people with an interest in stopping a fraud because they might be among those penalised if it were detected. You say in the communication that you could envisage the possibility of strengthening the principle, it has been the subject of lively discussions, but any such initiative would have to remain within the parameters of the Court of Justice ruling. That leaves me wondering whether you are saying anything in effect, because the Court of Justice appeared to take a pretty strong view. How do you steer between Scylla and Charybdis here? If “joint and several liability” would need to remain onside with the Court, how would it remain effective against a fraudster?

Mr Bill: Firstly, joint and several liability is permitted under the Directive now, that is clear. There is a provision in the Directive which says you can apply provisions of joint and several liability. What the Court has said is that when Member States do apply this provision it must respect certain principles of proportionality and certainty so that taxpayers are not taken unawares and it is not the innocent taxpayer that ends up taking the debt if the government is defrauded. The government cannot pass, if you like, its losses on to innocent taxpayers.

Q148 Lord Kerr of Kinlochard: If you have to rule out that possibility, does that leave much else? Mr Bill: There are two ways we can approach this. One is that we can revisit the legal provisions but, as you are quite rightly pointing out, this may not be particularly helpful because even if we amend the Sixth Directive, again the Sixth Directive has to respect the basic principles of Community law. Someone could then take the provisions of the Sixth Directive to the Court and have them thrown out, that is possible. What we have to do is to look at this very carefully, and we do not know the answer yet. It is one of these areas which we are now talking about with the Member States, the idea of co-ordination of action. This means we sit down together with the Member States and look at areas and say, “How is it going down here? Has it been received with any favour?” One of the ways we might be able to do that is by sitting down with the Member States and drawing up a framework, which could be in the form of a Commission recommendation or whatever, as to how to apply joint and several liability provisions whilst respecting the provisions of the Court. It may be that you could apply the joint and several liability provisions in intra-Community transactions by linking them to the fact that you have to establish if the goods have left the country and you have to establish that you have supplied them to someone in another country who has a tax registration and you have checked that number, and so forth. So you could envisage a reference of framework where you say, “If you do not respect these conditions as a supplier you could be liable to joint and several liability provisions”.

Q149 Lord Kerr of Kinlochard: I think that is a very good idea. Would the Court be prepared to go down this route? Mr Bill: What the traders have said to us in respect of joint and several liability is, “Yes, we understand joint and several liability but you have to be fair with..."
us. We have to know when we are liable”. If you put down clear rules which say, “If you do not respect these rules then you, as the supplier, could be liable”, that is fair, but if you say, “If your customer disappears without paying the tax you are liable”,—

Q150 Lord Watson of Richmond: “We are coming after you”!
Mr Bill:—and you have no control and no conditions to fulfil, that is unfair and that is where the Court is. I think we can construct something which would meet the test provided by the Court specifically in the area of intra-Community trade because there are certain conditions that you have to respect in order to be able to make this intra-Community supply without tax, which is the cause of the problem.

Q151 Lord Kerr of Kinlochard: That strikes me as a very promising way of doing it. Does that fall into the category, Commissioner, of the sort of thing that you feel might, if the discussion in April goes well, be possible in June?
Mr Kovacs: Yes.

Q152 Lord Kerr of Kinlochard: This is an administrative refinement of procedure. If the Court gave a positive avis, is it something the Member States would be prepared to accept now, in your view?
Mr Kovacs: Yes.
Lord Cobbold: It would mean more bureaucracy for business, more regulation, more paperwork.

Q153 Lord Kerr of Kinlochard: But less carousel fraud.
Mr Bill: Possibly less risk for business as well.

Q154 Lord Watson of Richmond: That is what I find so interesting, that they came back to you and said, “You have got to play fair with us”. If there is a reduction of risk, exposure on their side, that is the carrot, is it not?
Mr Bill: Yes. What we are doing on this is we are talking to business because honest business wants to help as well.

Q155 Chairman: Yes, I think they do.
Mr Bill: But they want to help in a way which is not disproportionate to them. What we have in mind is to have a conference in March with trade and all interested parties as part of the consultation process leading up to the April and then the June ECOFINs so that we, the Commission, can at least have an idea of how trade will react.

Q156 Lord Watson of Richmond: Can I ask a couple of further questions. It is almost a cultural issue really. Right at the beginning, Commissioner, you drew attention to this discrepancy between the 35 million traders, the billions of transactions and, I think, 20,000 exchanges of information. What do you really believe is the reason for that discrepancy? Is it avoidance? Is it indolence? Is it a cultural thing? What is it?
Mr Kovacs: It is a lack of trust, a lack of confidence that it will be successful. That is my assumption.

Q157 Lord Watson of Richmond: Is it worth it?
Mr Kovacs: They do not believe that it helps. Probably the other reason is that the exchange of information is very, very slow, extremely slow. When I first heard from some tax officials in the country that I know best that it can take two or three months to get access to the information I did not want to believe that and most of the business people do not have time to wait for that.

Q158 Lord Watson of Richmond: I think that is absolutely it, you have hit the nail on the head. Your communication basically said that once you have got feedback from the other institutions and the Council and the European Parliament and, indeed, other business groups and so on, you will launch a targeted action programme to combat fiscal fraud. What I have not quite picked up yet is what the timetable of this is and the degree of urgency that you associate with this. Is this just a general proposition or is it something that you are going to drive for against a certain timetable?
Mr Kovacs: The whole tax fraud issue is so general and complicated—

Q159 Lord Watson of Richmond: It is huge.
Mr Kovacs: It is very different in nature from those issues where there is a very concrete situation, a very concrete proposal and we can table it to the Council, to the Parliament, to the Economic and Social Committee, which has the right to form an opinion. It is different in the case of tax fraud. We want some general remarks, some general orientation, at the April ECOFIN. It is my expectation that we will receive some general orientation as to which way to proceed. If we see some strong reluctance to changing the VAT legislation I would not say we would give it up forever but we will put it aside, at least for the time being, and try to focus on the improvement of the traditional administrative matters to make some progress. I would not like to just wait and see and let another two or three years go by.

Q160 Lord Watson of Richmond: We really are coming up to a fork in the road basically and your estimate is this will emerge one way or another within the German Presidency.
Mr Bill: I think everything points to June as being the crossroads because, as the Commissioner said, that is when we would expect from the second round of discussion with ministers that we will get a clear orientation. By that time we hope that the European Parliament and the Economic and Social Committee will have given us their opinion on the communication. By that time we would have held our conference, we would have done all our consultations with business. In June I think we will have the feedback that we need to know which way to go so that in the second half of the year we can come forward with what we promised, which was a concrete action plan. What is going to be in that concrete action plan will emerge over the next six months and then we will come back with it in the second half of the year.

Lord Watson of Richmond: If the balance points towards going down the VAT reform route you are going to have an enormous workload on your shoulders over the summer of this year, are you not?

Q161 Chairman: My interests are slightly sectarian in this, Commissioner Kovacs, because I am trying to steer the production of a House of Lords report on carousel fraud and I am also, therefore, trying to produce it at the most helpful and useful moment when it is a contribution to the other debate. I feel that the conference of business in March is most definitely a very useful staging post because although that is largely talking about administrative measures there and they have not talked quite enough about other administrative measures, which I will pick up in a second, that seems to me to be a very important piece of the timetable. Then the June meeting is also an important piece of the timetable. I think one might aim to feed something into the June meeting or produce a report which the June meeting might bear in mind when it is doing it. We have not talked very much about the other administrative measures, such as greater co-operation between the states. There is a set of avenues to explore in your report: improving the functioning of co-operation; assistance in the field of recovery; improved risk management; a permanent forum for discussion at Community level—I think I thought it was ECOFIN—increased co-operation with third countries. Are we intending, therefore, part of the solution is to get the Member States talking so that we have already reached—

Q162 Chairman: Yes. Will this include trying to progress things like negotiations with the third states, states outside the EU? Are you making any progress with these or is this a list of things which we ought to be doing?

Mr Bill: This is a list of things we ought to be doing but, to put it in perspective, we adopted new legislation two or three years ago—improved administrative co-operation legislation—and it is a little bit like you can take a horse to water but you cannot make it drink. The legislation is already there and part of the problem is that Member States are not using the facilities which are there now. Part of what we have to do is to find out why it is that they are not doing that and how can we encourage them and in which directions should we encourage them to work because it is the Member States who control the tax, not the Commission, and we are only acting as facilitators. What we have to do is to try and help them to help themselves, in effect.

Q163 Chairman: “Why are you not talking to the Brits or the Germans or the French?”

Mr Bill: “Why are you only making 26,000 exchanges of information a year? How can we help, what can we do, where are there lacuna in the legislation? You have got to tell us where those are in order that we can improve that”. Part of our assessment is that it is not so much a lacuna in the legislation, it is a lacuna in using the legislation, and that is our analysis.

Q164 Chairman: That has been said to us.

Mr Bill: Therefore, part of the solution is to get the Member States talking so that we have already reached—

Q165 Lord Watson of Richmond: That was why I wondered whether it was a cultural thing.

Mr Bill: We are part of the way down the road to the solution in that Member States are talking, they have identified this, along with us, as a priority and they are discussing it and have put it on the agenda. Mr Steinbruck wants to have it on the agenda at the informal ECOFIN but he wants to have it on the agenda in June because he and a number of other Member States recognise the problem, that they have to talk about it and, therefore, we hope the solutions will come out of that discussion. We are not omniscient in terms of coming up with the solutions.

Lord Kerr of Kinlochard: Come, come!

Q166 Lord Cobbold: If our report helps to develop the argument it will be useful.

Mr Kovacs: When we presented this communication in June at the last ECOFIN meeting under the Austrian Presidency the reaction was, “Yes, it is very good and we appreciate it”.

Mr Kovacs: I think yes. Just returning to the first part of your remark, I can promise to keep you informed. We can send you some reports and a summary after we have had the March conference with the representatives from business. We can also provide you with some information after the April informal ECOFIN and after the June ECOFIN and then you can follow the whole procedure.
Q167 Chairman: Excellent. Good stuff.
Mr Kovacs: It takes time for Member States to consider it seriously.

Q168 Lord Kerr of Kinlochard: Have you persuaded the ministers of finance, not the tax ministers, not the revenue ministers, not the ministers in charge of indirect taxation, that this really is a big issue which they need to grapple with? I speak from memory, and maybe the present generation of ministers of finance are quite different from the ones I remember, but I remember finding it very difficult to persuade finance ministers to stay in the room when topics of this kind were under discussion. It would be the junior minister responsible for the Fiscal policy who would be left and, of course, it would be the finance minister back home who would receive the criticism from the lobby for an over-heavy, interfering system. I used to think it was unfortunate that those arguing for co-operation did understand each other but were not the senior ministers responsible for the system at home.
Mr Bill: I think ECOFIN has learnt that lesson. What happens now is that tax matters only appear once or twice under a Presidency and we have increasingly what are called Tax ECOFINs, so we will have nothing on the January and February agendas, we will have March and probably June that are tax issues and there will be—
Mr Kovacs: And May.
Mr Bill: And May. The tax items are now concentrated with a view to counter this problem. Secondly, it has become more and more apparent that the only thing ministers really have a discussion about now in ECOFIN is tax.
Mr Kovacs: Where there are conflicts of interest.
Mr Bill: Most of the other things are either euro group or rubber-stamping in ECOFIN. The only real debate which takes place now in ECOFIN is on tax and we concentrate those tax issues in two or three ECOFINs, so there is plenty to get your teeth into.

Q169 Lord Watson of Richmond: What you are describing is quite a major change, is it not?
Mr Bill: It is. It has evolved over the last three or four Presidencies.

Q170 Chairman: If I may say so, I also think that Commissioner Kovacs’ view that you frighten people by reminding them how much tax they might be losing might actually get the attention of a few ministers of finance. This is a useful idea.
Mr Bill: This is certainly the case for those ministers who are concerned. For example, Mr Steinbruck is very concerned; Mr Grasser is very concerned, the Austrian Finance Minister; the Spanish Finance Minister is very concerned. It is the finance minister, not the tax minister, who is concerned.

Q171 Chairman: I think it would be fair to say that our Chancellor is concerned rather than the minister in charge of tax, who is Dawn Primarolo.
Mr Bill: I think she is concerned too.
Chairman: I am sure she is concerned too but I think our Chancellor has now noticed that it is quite a lot of money that has gone missing with which you could build things, which was exactly your point, Commissioner Kovacs. Colleagues, we are approaching the end of our time with Commissioner Kovacs, does anybody else have anything they have failed to ask or would like to ask?

Lord Watson of Richmond: I hope you have got the impression from us that we quite like your £250 billion.

Q172 Chairman: Indeed. We have found this session very helpful. Thank you very much indeed for seeing us and for dealing so patiently with our questions. If we may keep in touch and be kept in touch we should be most grateful.
Mr Kovacs: We will certainly deliver the information.
Chairman: Thank you very much.
TUESDAY 30 JANUARY 2007

Present  
Cobbold, L  
Cohen of Pimlico, B (Chairman)  
Giddens, L  
Inglewood, L  
Jordan, L  
Steinberg, L  
Watson of Richmond, L

Memorandum by the Institute of Chartered Accountants in England and Wales

WHO WE ARE

The Institute of Chartered Accountants in England and Wales (“ICAEW”) is the largest accountancy body in Europe, with more than 128,000 members. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter “TAXline” to more than 11,000 members of the ICAEW who pay an additional subscription.

INTRODUCTION

1. The Tax Faculty of the Institute of Chartered Accountants is pleased to respond to the call for evidence by Sub-Committee A in its enquiry into the issues surrounding VAT carousel fraud.

2. It has always been possible for a person in business to disappear without paying VAT. As long as businesses collect tax which they are required to pay over to HM Revenue & Customs (HMRC) that possibility will always be present. MTIC fraud and carousel fraud however are on an altogether different scale. We agree that the prevalence of the MTIC fraud and the huge sums involved warrant urgent action and we support HMRC in their battle to eradicate it.

3. We understand that MTIC fraud is perpetrated by a relatively small number of people. By now they must have considerable assets which they have no doubt sought to hide. We assume that police detection techniques have been employed to identify the guiding minds of the fraud and their assets. Clearly sufficient resources must be allocated to this task. This is a crucial first step in reducing or eradicating the fraud.

4. Tax fraud undermines the tax system and sends the wrong message to those who pay their taxes. We support the provision of extra resources to fight this fraud. There is a need for specialists and the right type of resources.

THE ORIGIN AND CAUSE OF MTIC FRAUD

5. In theory VAT is a tax that is easy to collect and is to a large extent self policing. It is difficult to avoid or evade. Tax is collected from businesses at each stage of the production cycle. The tax at risk of fraud or non-collection is limited to the VAT on the value added by the last trader. However, in 1993 a departure from the normal VAT system was introduced which created the opportunity for MTIC fraud. MTIC fraud relies on the system of zero rating of goods supplied to a registered trader in another member state. Without zero rating for goods crossing the borders of member states MTIC fraud could not exist.

6. According to the Budget 2006 Red Book (Table C8 on page 262) the receipts for VAT for 2004–05 were £73 billion. The latest HMRC estimate for MTIC fraud is that it cost the UK between one and two billion pounds annually, although later estimates have put this up to £8 billion.

7. The Single Market system for accounting for VAT on movements of goods between member states is known as the transitional or destination system. No VAT is charged in the country from which the goods are despatched. Tax is accounted for under the destination system in the country receiving the goods. The re-introduction of border controls abolished at the start of the Single Market in 1993 is not a practical possibility and would not meet the objectives of the Treaty to create a common market identical to an internal market.

8. In planning the Single Market, the Commission pointed out the danger that the VAT-free transfer of goods between taxable persons in different member states gave rise to the possibility that some of those goods would leak into free circulation without tax being paid. It thought that the destination system was prone to abuse and evasion.
9. The Commission recommend the origin system under which VAT is charged in the country of despatch and the trader in the other member state reclaims the tax in his own country just as for domestic transactions. That way, no movements of goods would be VAT-free. However, a means had to be found to give the business in the country of acquisition relief for tax paid in the country of despatch. To do that the Commission proposed a clearing system. That was rejected for a number of reasons, including that of political sovereignty. Operationally, it was claimed it would be too complicated and too costly to operate. It was of course nowhere near as complex as the clearing systems operated by banks and credit card companies. The cost of the system is likely to have been relatively insignificant compared to the cost of the fraud that has taken place since 1993.

10. The destination system is known officially and in the Directive as the transitional regime. The Commission still favours the origin system as the definitive regime and if the Community wishes to move to a true single market that is identical to an internal market some form of clearing system is inevitable. We think the UK and other member states should review their objections to both a clearing system and the origin system in the light of experience since 1993. A number of misconceptions entered the decision-making process in the early 90s. For example the harmonisation of rates of tax in member states is not essential in order to operate the origin system as was previously thought (although it makes it simpler). A clearing system would pave the way for the single VAT registration of traders operating in more than one member state and would complete the internal market—a cherished objective of the Community. We think there should be a review of the practicability of a clearing system and whether it will reduce the risk to the collection of tax. The objective is to strengthen the structure of the tax and to make the revenue derived from it more secure. However, we recognise that any move to an origin system will take time. Accordingly, other more short term solutions are necessary to fight MTIC fraud and we consider these below.

HOW MTIC FRAUD WORKS

11. In its simplest form MTIC fraud is carried out by a VAT-registered trader who acquires goods from a VAT-registered trader in another member state. The goods enter the UK VAT free and they are then sold to another business in the UK and VAT is charged on that supply. The supplier then disappears without paying the tax. If the UK business customer supplies the goods to another VAT-registered trader in another member state the same goods can leave the UK and then be brought back to the UK where the fraud can be repeated. The UK business customer may or may not be aware of the fraud. The goods may or may not actually cross the borders of member states and the paperwork purporting to evidence such movements may be false.

ACTION TO PROTECT INNOCENT TRADERS

12. Guidance has been published by HMRC to help traders avoid being unwittingly involved in MTIC fraud. Some may be naive, gullible or greedy but otherwise innocent traders who are more likely to be caught up in fraud. They should be treated as compliant traders unless there is evidence to the contrary.

13. In the linked cases of Optigen (Case C- 354/03), Fulcrum Electronics (Case C-355/03) and Bond House Systems (Case C-484/03) the European Court of Justice held that transactions not otherwise vitiated by VAT fraud constitute supplies of goods for VAT purposes. They are an economic activity regardless of the intention of someone else involved in the chain of supply and/or the possible fraudulent nature of another transaction in the chain either before or subsequent to the transaction carried out by the taxable person and about which he had no knowledge and no means of knowledge. The three companies submitted VAT returns claiming large repayments arising as a result of purchases of computer processing units. HMRC rejected the claims on the grounds that the purchases formed part of a carousel or missing trader fraud designed to obtain repayment of large sums that had never been paid as output tax. HMRC argued where goods move in a circle of transactions through the same chain of companies for the purpose of stealing VAT, there is no economic activity and no VAT is payable or repayable on the transactions. The ECJ rejected this argument and found that transactions within a fraudulent trade can fall within the Directive and within the scope of the tax. On 18 January 2006 the Commissioners issued Business Brief 01/06 setting out their practice in the light of the Court’s decision.
New Reverse Charge

14. In our briefing paper to MPs relating to the Finance Bill this year we welcomed the proposal to apply to the European Commission for a derogation to introduce the reverse charge. We note that the Commission have now proposed this, although it still has to be approved by the Council. We agree that the reverse charge is useful (we recommended its adoption in 2003), although it can only be a partial and temporary solution to the problem.

15. There is a risk that the fraudsters may quickly turn their attention to goods not subject to the proposed reverse charge and/or to services. Secondly, we have a number of concerns on the detailed application, speed of introduction and the consequent burdens on business generally. For example, we consider that the £1,000 *de minimis* limit is far too low, since the average transaction involved in the fraud appears to be well over £100,000. We also think it preferable not to require retailers to operate the reverse charge on their supplies because it would be difficult for the fraudsters to carry out MTIC fraud by operating as retailers.

16. HMRC accept that the reverse charge introduces a further weakness into the system, since it defers payment of tax to the Exchequer until the last link in the chain of supply, where the whole of the tax charged to the consumer is at risk of non payment. Under the normal VAT regime tax is paid to the Exchequer at each stage of the production cycle and the tax at risk is only the amount of tax on the value added at each stage.

Further Action

17. In the following paragraphs, we list a number of further measures which could be introduced to counter the fraud. Since all of them would place some additional burdens on innocent businesses, HMRC would need to be certain that they could operate them promptly and efficiently.

VAT Registration

18. HMRC quite properly need to carry out checks to ensure that the applicant is a legitimate business. However, there is also a need to register legitimate businesses quickly and efficiently. At present, the delays in VAT registration are unacceptable, and hold back the development of new businesses.

19. Commercially available information, such as that provided by the credit agencies, may assist in building up a risk profile. It might also be useful in relation to changes of ownership and transfers of going concerns. Fraudsters can avoid registration checks by taking over an existing business already VAT registered.

“Credit Limit” for Input Tax Recovery

20. When a businesses files a VAT Return making an unusually large VAT repayment claim, HMRC will carry out a credibility check before authorising the repayment. In MTIC fraud, the claimant is not the fraudster himself but often the business that purchased the goods from the fraudster. If that business is not involved in the fraud, HMRC are faced with an impossible task at that stage—the fraudster has already charged VAT to the business, collected it and disappeared.

21. We have suggested to HMRC that they could consider a limit (like a credit limit) on input tax claims for a VAT return period. If the limit is going to be exceeded the trader should be required to notify HMRC in advance and obtain their approval. Failure to give notice would mean a delay to the repayment whilst a thorough investigation is carried out.

22. We recommend that the limit be set at a generous level so that the trader will only rarely have to give notice of an unusual claim such as when he buys premises or there is a major change in trading. For example a business whose input tax claims average £50,000 for each VAT Return period could be given a limit of £100,000. A transaction limit could also be set.

Transfers of Going Concerns

23. A fraudster involved in MTIC fraud may prefer to take over an existing VAT registration in view of the delays in obtaining a new VAT registration. We think that checks, similar to those made on new VAT registrations, should be made when there is a transfer of a going concern. There is already a requirement to notify HMRC within 30 days of the change of ownership. HMRC could consider whether it would be useful to require the transferor to obtain clearance from them in advance, and to specify the nature of the new trade.
30 January 2007

**CHANGE OF CONTROL OF COMPANIES**

24. HMRC could consider introducing a requirement for a controlling shareholder to notify on the sale of a controlling interest. For this purpose the controlling shareholder’s holding should be treated as including those of connected persons. Until such notification, the controlling shareholder would be responsible for the VAT obligations of the company. We think that checks similar to those made on a new VAT registration should be carried out where there is a change in the control of a company.

**JOINT AND SEVERAL LIABILITY**

25. Since 2003 there has been a new joint and several liability relating to the supply of specified goods (computers, telephones etc). A taxable person who supplies specified goods can be held liable for VAT on a previous or subsequent supply of the same goods where he knew or had reasonable grounds to suspect that the VAT would go unpaid.

26. In practice we think that this is a very difficult liability to enforce in the case of those involved in MTIC fraud. The necessary evidence is not normally available.

**HMRC'S nemesis DATABASE**

27. We think that the operations designed to capture data on unique identifier numbers in relation to mobile phones will have an impact in reducing fraud involving the goods identified. Unfortunately, it requires a great deal of administrative work, and may only divert the fraudsters towards other goods.

6 October 2006

**Memorandum by the Association of Chartered Certified Accountants**

**INTRODUCTION**

In simple terms what is being discussed is that the Government exchequer is being defrauded by the theft of input tax on cross border transactions. It is very specific and of a much higher magnitude, generally speaking, than most other forms of leakage from the VAT system. The opportunity for this largely occurs because of the lack of VAT on cross-border transactions.

**SIZE OF THE FRAUD**

In speaking to HMRC in the preparation of this short paper it is clear that the size and scope of the fraud can only be guessed at but is likely to be somewhere between £2–3 billion. This figure is much lower than some of the figures which mentioned by others but I suspect is actually fairly realistic because HMRC are “embedded” in the system and are likely to be much more aware of the intricacies of the fraud.

**HOW IS THE FRAUD DEALT WITH AT PRESENT**

The clear emphasis seems at present to be one of using intelligence to stop it and withhold input tax wherever they suspect that it is about to be perpetrated. The biggest issue seems to be that there may be many innocent traders who are being caught up in the fight and are having their input tax withheld. Feedback we have been receiving indicates that some traders are moving out of the targeted sectors because they cannot afford the risk of not receiving back the input tax or being targeted by HMRC purely because of the business sector they operate in.

**SOME POSSIBLE RESPONSES**

*The current reverse charge proposal*

The proposals as presently anticipated should make a significant difference to the magnitude and scope of the fraud. There are however questions over the operation of such a low de minimis. However we have received informal assurances that they will operate the regime with a light touch.
A MINIMUM TAX RATE

Instead of zero rating cross-border transactions perhaps they should be sold with some tax attached to them: perhaps 10 per cent to 15 per cent (but only on high value low weight goods such as computer chips and mobile phone simcards). Therefore the profitability of fraud in relation to such items would diminish considerably. However such a move would require trust and co-operation between member states so that the VAT collected was passed through to the purchasing country.

BETTER INFORMATION EXCHANGE MECHANISMS

The Commission is quite correct to identify mutual co-operation as an area which could work better. We wonder whether there are adequate means for fast cross-border information exchange. It is very controversial to say but should we be thinking much more outside the box. Should member states offer direct access to their data bases through secure links to other member states. It seems that many times the fraudster manages to execute a fraud because member states are unable to move fast enough.

GREATER CORRELATION OF INPUT TAX AND OUTPUT TAX

Some member states have put this proposal on the table. They consider that this is really the only way, other than through the introduction of an origin system, to deal with this type of fraud. While the idea is not superficially bad in reality it will cause businesses huge problems in terms of cash flow. In addition it will be extremely difficult to have IT systems which can adequately deal with such complexity.

ORIGIN SYSTEM

The attempts by the commission to introduce this in the 1990s died due to the lack of ability of member states to agree with one another and to have trust over the need for the existence of a clearing bank. We do not believe that we are any close on trust today with the enlarged EU nor do we believe that the member states will have the will to agree a common set of rules and rates which are likely to be needed for traders in one member state to accurately invoice the customer in another.

CONCLUDING COMMENTS

We do not believe there can easily be a single solution to the present VAT regime in the EU in relation to missing trader fraud. If there is no will for an EU wide single VAT system then by necessity much of our approach will be one of putting sticking plasters over the problem areas.

22 January 2007

Examination of Witnesses

Witnesses: Mr John Arnold and Mr Ian Hayes, Institute of Chartered Accountants in England and Wales, and Mr Chas Roy-Chowdhury, Association of Chartered Certified Accountants, examined.

Q173 Chairman: Good morning. Welcome to this inquiry. Thank you very much for coming. You will be provided with a transcript of what is said, so that it does not need to be a total mystery. I know we sent you a truckload of questions which we are going to group this inquiry around, but I would like to ask whether all or any of you would like to make a short opening statement or whether you would like us to go ahead and ask questions.

Mr Arnold: I will be brief. When my colleague said this was the main statement, that is not so, but it is just trying to bring out some of the main points that we will perhaps get to in some of the questions later. The position we have on MTIC fraud is a little like that if we had a chain of jewellery shops from which there had been a series of thefts and we then discovered that the main opportunity for the theft was because there was no glass in the window of any of the shops. The response seems to be to look at
controls on passers by and on customers, whereas we see the answer—one can debate how and we can discuss that later—as really being the question of how you put the glass back, how you close the gap that we created in 1993. We see difficulties in the approach from HMRC because they are having policies determined elsewhere, so one needs to look at the state as a whole perhaps. They are short of staff, they are reducing staff, as we have seen, and they have archaic computer systems which cause problems in looking at any of the modern systems of tracking transactions, the real-time tracking of transactions like we have with credit cards and so on. I think the question of the UK derogation will come up later. The final point which causes a little concern, which comes out in some of the questions as well, is that we have seen some evidence through the courts and elsewhere of the pursuit, if you like, of the innocent rather than the guilty. That has come through in the papers and I wanted to repeat that here. There is a group litigation order of 50 companies in front of the High Court looking for damages. We saw the FTI announce last week—and I think they are giving evidence to this Committee—that they are also seeking judicial review. There is a big question of proportionality here. They are the points I would like to make at the beginning, my Lord Chairman.

Mr Roy-Chowdhury: I would echo what John Arnold has said and also what Ian was saying. The point of all this is that we have a system within the European Union which is very much predicated by national governments trying to control their own national fiscal pot. As long as we have that mindset, we are not going to get to the bottom of trying to resolve the key problems which give rise to the opportunity for MTIC fraud. The opportunity was there in the late nineties, with the idea of the origin system, the definitive VAT system which was going to come in, but the political will was not there to take that forward. We really need a proper debate and discussion about how to deal with a wholesale approach to the VAT system which will block the opportunity for MTIC fraud and I just do not think the political will is currently there to do that. All we are really doing is taking a sticking plaster approach. We have IT systems which are not able to operate effectively across borders, where one fiscal body does not have access to the IT system of another fiscal body in another state. We are giving the fraudsters a real leg up in being able to conduct the frauds because of the way that we have different VAT systems in different jurisdictions. We do not have proper IT tracking available real-time. I just wonder at what stage the loss of revenue is going to be big enough for governments to have the political will to come together and create a single VAT system across Europe.

Q174 Chairman: Thank you very much. Perhaps I could start off by asking, as a general item, to not repeat each other where you agree. Of course, that said, I welcome any comment from anybody. As an opening question, I would like to ask whether missing trader fraud is a bigger problem in the UK than other European countries or is it just that we are better at detecting and measuring it? As a supplement to that, can you offer any insight into why Germany have proposed a reverse charge on goods?

Mr Arnold: We see no particular reason why the UK should be a more popular place. The only point, perhaps, is that VAT returns in the UK cover three months and they normally cover one month in most Member States, so other Member States would be alerted to the transactions at an earlier stage. If we take the Netherlands, for example, there is e-filing as well of your returns, so you would tend to get the information in a form that you could also use and put in risk parameters and so on that much faster rather than having to input manually as we do here. I saw from some earlier evidence that we were saying the UK repays faster. That is true in some cases, but the Netherlands would make a normal VAT return repayment within two to four weeks, so we are not looking at a big difference there. I think it is just that there has been more publicity and more candour as to the existence of the fraud in the UK. There was a press report in France that the French equivalent of the Federation of Trades Unions had said that there was €14 billion of fraud last year in France and that was quickly denied by the French Government. We do not have estimates that are accurate.

Mr Roy-Chowdhury: I would tend to agree with John that we are more candid in the UK, but, also, the repayment point is something. Certainly some European countries, when I speak to HMRC, have pointed a finger at the UK, saying “you’ve brought it upon yourself” to paraphrase the kind of comments that are made. I think the real problem is that we do not really know what the estimates or the real fraud amounts are but I do suspect that perhaps in the UK we are better at airing the figures. The £2 billion to £3 billion I mentioned in my note, and which is generally mentioned by HMRC, probably is realistic and based on that we have quite a lot we need to get done. At the same time, we are going the right way around it in the UK by debating fairly openly what the problem is, the quantum of the problem and how we need to resolve it.

Mr Hayes: This is a fraud that is cross-border, so it involves more than one country. I think you need to consider the criminals who perpetrate the fraud. They are clever; they know what they are doing; they know how to use the system or the systems; and, when they look at the systems, they will choose that country which is the easiest target and they will locate themselves in another country. The Netherlands, for example, will maintain that they do not have very much of this fraud activity because of the measures
that they take against it. Those measures do not seem that different from ours, although, as John said, they have electronic filing of VAT returns and they have VAT returns done on a monthly basis rather than a three-monthly basis. But it is quite conceivable that criminals using the system for their own benefit may decide that they are going to locate themselves in the Netherlands because that community is where they are going to site the profits of their activities and launder them or use that location—and not necessarily the Netherlands, it could be some other country. I thought it noteworthy that in the evidence of Commissioner Kovacs he said that the reason he thought the French objected to our derogation was the fact that if it were granted the criminals would move from here to France.

Q175 Lord Steinberg: I often think, since this problem arose, that it is a question of closing the stable door after the horse has bolted. It is obvious that this fraud has been going on for some considerable time. I completely agree with you that the people who are perpetrating this type of fraud are very sophisticated people. It is not, in my opinion—and I would ask you whether you agree with me or not—some little guy selling mobile phones or washing machines and fiddling for a few thousand pounds or euros. These are highly sophisticated people who have been planning and dealing with this and they switch. Maybe I am the only one old enough to remember the dollar premium. You are? When the dollar premium was used, sophisticated criminals found a way to be able to claim that. Is this fraud a coordinated and sophisticated attack, on the VAT system—although surely it is on any system—which they can use to their advantage? I know that some of them—and I have to say “so-called criminals” because some of the cases are still under court hearings—are actually suing the authorities to reclaim money which the authorities believe they are not entitled to receive. My question is: how sophisticated is the operation in your opinion? Obviously we will then come to how we can adequately take steps to deal with it.

Mr Arnold: I personally have not come across these criminals at first hand, as such, but my understanding is that it is very sophisticated. It is similar to money laundering activities, I guess, done in a way that is highly professional, by people who are very bright, using the system. If we did not have VAT, then clearly, as you say, we would not have this fraud. It is probably the level of VAT which we have, double-digit rates of VAT, which is the inducement in Europe. In terms of ways to combat it, I have already mentioned the political will for a VAT system across Europe. There may be other halfway houses, such as the reverse charge derogation which the UK is seeking, but there may also be a need to think of the idea of operating a certain level of VAT and maybe just on specific goods across borders, which would then reduce the profit from MTIC fraud. It could be that we would operate a cross-border rate of VAT of, say, 10 per cent on specific goods. That could be another way of perhaps tackling it, but it is really a sticking plaster approach and it is very difficult to see how we can totally eradicate the fraud as long as there is a disconnect between Member States and the VAT systems.

Q176 Chairman: We are really trying to get our hands on whether, should any two Members here decide to set up a fraud, we could do it. Or is it more complicated and sophisticated than that?

Mr Arnold: No, it is not more complicated. In 1992 when these proposals came out—and perhaps I should stress that it was a joke but it is a sick joke now in view of the results—I was with a very senior official of the Commission, a very senior official of the then Customs and Excise and we had this sort of fantasy partnership to commit this fraud. It was really an intellectual exercise in seeing the weaknesses of the system. This was even before it came in, so this is why, when we say people knew about it, that is not hearsay, it is to my certain knowledge. Yes, you could. It is probably, with the additional controls we have now, harder than it would have been a couple of years ago, but you could.

Mr Hayes: The comment I would make is that this particular fraud in some ways picked the perpetrators. They stumbled across it by accident rather than deciding this is where they would go. However, having found it and the monies that could be made from it, word spread very quickly. The one thing that is required within the fraud is some financier coming in to provide the funds and, at that stage, I think organised crime saw this as an opportunity to make a lot of money at the expense of the Member States of the Community. It was at that point—and I think that is something that has happened within the last seven to 10 years—not immediately from the introduction of the single market, but now I think the players in there are very hardened criminals.

Q177 Lord Steinberg: I think we would all accept that somewhere in these criminal activities there is Mr Big and that Mr Big probably does the financing, but are you saying that the system is so capable of being overturned that if we were able to get some agreement with cross-border activities we would still have this degree of fraud? We had Commissioner Kallas here last year, not dealing directly with missing trader fraud. He was, at the time—and I think he still is—in charge of OLAF and he had, if I am correct, 586 cases investigated but there has not been one single prosecution. That kind of
information frightens me. Surely the only way we can solve this is by going out after Mr Big and his organisation?

Mr Hayes: I think we would all totally agree with that. As Mr Roy-Chowdhury said, with which we totally agree, there is a lack of political will within the European Member States to deal with this. The solution to this is a solution that is dealt with at Community level by cooperation between the Member States, because the fraud is a fraud that is perpetrated on the Member States collectively, not individually. Going back to the point about the use of Member States, I think this fraud is a fraud that does have a degree of locality, to the extent that, in the UK, the other countries that we see involved are Spain, Ireland, France; in other words, the local countries. In Germany, one is looking more at Austria, going over the border, out of the Community, into Switzerland. Whether there is anything in Sweden or Denmark, I do not know. That is not an area that I am au fait with. I think the solution to this problem must come at Community level and it must have the entire support of all the Member States, very proactive support.

Q178 Chairman: Could I be allowed a supplementary question on financing. They told us in Brussels that it had greatly helped to close one of the banks behind this.

Mr Hayes: Yes.

Q179 Chairman: I do not quite know how you close a bank but that is what they did.

Mr Arnold: Arrest the major shareholder and hold him in jail in the Netherlands is one way.

Q180 Chairman: That is a good way of closing a bank. I am sure.

Mr Arnold: Which is actually what has happened.

Q181 Chairman: It was suggested to us that that might cut 60 per cent of the problem in Britain, and that made me think, “Oh, well, if that’s all it takes . . .” Could you comment on that.

Mr Hayes: If you look at this as an issue of fraud and not as an issue of the problem with the legislation—which I think is a separate issue which needs to be dealt with—the major way to combat fraud is to follow the money. We understand that there are very large sums that have gone missing as a result of this fraud. The question in my mind is immediately, “Who is following those sums?” because there must be a trail. That has started to happen. John was referring to a bank in the Netherlands Antilles, which figured in a large number of the MTIC fraud cases we had in this country. It was used because, within the way fraud operates, if you have to follow normal commercial practice of monies going from A to B to C, the one thing you are going to lose out on is the possibility of the fast transmission of funds so that you can get in and get out quickly without being caught. This bank in the Netherlands Antilles, was used and transactions were all carried out within that bank.

Q182 Lord Giddens: Your argument that the solution has to be a Community-wide solution is very powerful really, it is irresistible, but we know it is not always easy to get agreement between the Member States and the European Union. Supposing no agreement is reached and we have to struggle on in the existing situation, what are the limits of what nations can do? It says in some of the material that the Barroso Commission says that 1,500 people are being employed to counter this kind of fraud. Do you know how effective they are? Are they doing the things you just mentioned in tracing the money? Could there be sub-regional associations of countries in the way you seem to be hinting at. You might get a group of countries in close proximity who would work together in some way.

Mr Hayes: A personal view is that this is criminal activity. When Revenue and Customs were put together, one of the issues was the issue of pursuit and investigation of fraudulent transactions and whether or not SOCA should be employed. If you look at the involvement of SOCA, it is at the invitation of HMRC and HM Treasury. What you have here is a fraud of the quantum that requires the involvement of SOCA because SOCA has the resources. It has the powers that are necessary to pursue this sort of crime. That is certainly one of the things I would wish to see happening very quickly.

Q183 Lord Giddens: Which estimate of the total amount of money involved do you tend to side with? There are different estimates of the amount of cost to the country: some say £2 million and others say £5 million.

Mr Arnold: There would be one hard number that we have not seen amidst all the estimates. This is the problem. When you met Commissioner Kovacs, he was talking about €250 billion across the Community. It then turned out that that was not fraud, it was a combination of fraud and avoidance. Avoidance is legal. One can debate avoidance for the rest of the week, but the fact is if you mix the two up the total is not very illuminating. At the end of the day, one has to look at fraud and then what is MITC fraud. The one hard figure we have not seen on MITC fraud is missing trader. What is the VAT that has been received by those missing traders? That would be a hard figure because these businesses have not filed the returns, who has paid them, et cetera? One
would be able to get to that number and one could see; otherwise, it is all educated guesswork, quite frankly, which is not a very helpful answer.

Mr Roy-Chowdhury: I would probably side with the HMRC figure of £2 billion to £3 billion in the UK. That is probably a fairly realistic figure, given that they are embedded within the system. I think the measures they are taking are being effective to some extent but, as I said before, the criminals are very bright individuals. They are very motivated, obviously, with the amounts at stake and they are always ahead of the curve from where HMRC can get to. In some ways we need to think outside the box. If we are going to not have a single VAT system across the Union, then we need to think in terms of better access to real-time data across jurisdictions—which is unthinkable perhaps where one national jurisdiction, say the UK, has access to the Netherlands database real-time—so that we can track fraudsters real-time across borders and try to stop it. That is really a part of the problem, where the fraudsters can get away before the national jurisdiction fiscal authorities can even get the information to deal with them.

Q184 Lord Steinberg: Two new entrants have a history of irregular behaviour in taxation. Do you not think they would become prime targets for these criminal activists to start setting up their carousel from those new countries?

Mr Roy-Chowdhury: I am sure the type of criminals involved would already have looked at those new jurisdictions as opportunities for expanding their criminal activities. Yes, I am sure they would have been looked at and frauds may be being perpetrated from those new entrants. We are very focused on these low weight/high value items but I have also heard that in southern Europe, for example, Mercedes cars are being used in MTIC fraud; there is the opportunity on the service side to use bogus invoices. There are all sorts of other opportunities which may be being used, which are perhaps background noise at the moment and not being picked up in the mainstream, which are there waiting to take over even if the UK gets a derogation. I think we need to be very careful about the sticking plaster approach. If we do not have a holistic view of how to deal with the system completely, then there are going to be gaps which are going to be taken up by these fraudsters, and, as you say, in terms of new jurisdictions as well.

Chairman: If I may, I would like to try to move this on; otherwise, riveting though this is, we will not get through our agenda. Our questions run under two headings. The first is with regard to the short-term measures that are going to be of any use in combating this—and I think we have exhausted some of them—and the second is with regard to the long-term solutions.

Q185 Lord Inglewood: Each of you is an expert in all of this. Certainly, speaking for myself, I am a layman looking at the problem for the first time. It seems to me that one of the really important questions on which we need to get an expert view is, given we are where we are, given we have the European Union, given we have a VAT system, given the fraud is going on, is it possible, do you think, to deal with this abuse through essentially administrative measures—and we have touched on things that would help—or is it actually the case that there has to be a root and branch reform of the VAT system and the taxation system, arguably, more widely, in order to stop this leakage of public money?

Mr Arnold: It depends what you want to do. If you want to stop the opportunity for fraud, then you have the root and branch change. You have to change the VAT treatment of cross-border supplies. If you cannot do that but you want to make it more likely that fraudsters will be caught, then we can look at the sticking plasters.

Q186 Lord Inglewood: What I want to do is to stop this money going walkabout. If that is your primary purpose, is it possible to do it administratively in a realistic way?

Mr Arnold: Not in my view.

Mr Roy-Chowdhury: I do not think you would completely stop it. I think there are ways of mitigating it, which is really what we are trying to do in terms of reverse charge. The other thing which I have mentioned is if you could have some level of VAT which applies across borders. At least that then means, say you have a 15 per cent rate, that the margin of fraud is 2.5 per cent. There are other areas, but then you are going to have to trust other Member States and that is where things start falling apart. There needs to be a will. This cannot go on. While HMRC are being fairly effective, as far as they are going, and other Member States are trying to do the same, there is still an awful lot of money escaping out of the system and there needs to be political will just to clamp down on that and perhaps a minimum rate of VAT is a step they are willing to take.

Q187 Lord Inglewood: If an artery is cut, you can staunch a bit of blood by putting on a small piece of cotton wool but it will not stop you dying from blood loss. In terms of mitigating the loss, is the mitigation realistically possible, in your judgment, going to be such that it will make a material difference to the amount of money that is disappearing or is it frankly all a fig leaf in front of the nakedness of the underlying system?
Mr Hayes: Contrary to a lot of the submissions that we have made, where in 2003 we advocated the reverse charge mechanism at a time when the joint and several approach was adopted by HMRC in the Finance Act, at that time we felt that would go some way because we were looking at what had happened with gold and there were some similarities. Judging by the information that has been made public by revenue authorities throughout the Community, this fraud has escalated to an extent that we now do not think that approach will have any significant effect because it is possible to apply the method of the fraud to any number of different forms of goods, so if we get a derogation in respect of chips and phones we will then have to look at razor blades, which is one area, or car tyres, which is another. We just cannot keep on specifying goods. That is not going to work. The fraudsters will now just go where they can and they are in and out. Conventionally, looking at registrations has been one of the areas of seeking to control the fraud. That, in my mind, is not going to produce any substantive result for the simple reason that fraudsters now are taking over companies. These are evil men. If you have had evidence given by HMRC, some of the people who work in HMRC will give you information about criminal activity involved with fraudsters getting involved with other registrations and using other registrations.

Q188 Lord Inglewood: Really you are telling us that we need a root and branch reform of the VAT system in order to staunch this haemorrhaging of money.

Mr Hayes: On this aspect of it, yes.

Mr Arnold: We have great sympathy for the Committee: the obvious answer that would do it, we cannot see happening, and so we then start looking for the less obvious answers, which are, by definition, less effective as well.

Q189 Lord Inglewood: Yes, I take that point.

Mr Arnold: That is the difficulty that we have.

Mr Roy-Chowdhury: In some ways in the VAT system, we are not that far behind getting a harmonised system. We already have the six VAT Directives upon which all the other VAT systems around Europe are based, but it is purely trusting other Member States with your money and getting it back under a clearing bank system which is really the main stumbling block.

Mr Arnold: It might become preferable to trust other Member States with their money than to trust fraudsters.

Q190 Lord Inglewood: One of the problems about the clearing bank system was that there has been anxiety on behalf of the governments of a number of Member States about the sovereignty implications of that initiative. That is what I call a political problem as opposed to a technical problem.

Mr Arnold: Yes, that is right. Please stop me, my Lord Chairman, if I am straying into the wrong question, but that is why the Commission come up with the One Stop Shop.

Q191 Lord Inglewood: You have identified the important issue here.

Mr Arnold: We have identified that issue. The problem with a One Stop Shop is that it is actually a 27 Stop Shop and would be very distorting for intra-Community trade.

Chairman: It is inevitable that we stray in and out of questions in a session like this.

Q192 Lord Jordan: I am coming in now because you have just been talking about the area I was going to ask you about. You have made it abundantly clear to us that the small tweaks, the sticking plasters, are not going to tackle this. You have also said—and I do not think there is any doubt about the truth of what you have said—that the sort of draconian measures that would be needed would not be politically acceptable. We are going to look at something pragmatic at the end of the day. We realise that one is not good enough; the other is not acceptable. Could you give us three things that in your view would be politically acceptable which would have the biggest impact on the present methods of fraud in this area.

Mr Hayes: (i) I think setting up a pan-European taskforce, with members from the revenue authorities of every Member State, specifically to deal with this; (ii) the Commission taking on responsibility for setting greater parameters for the monitoring of intra-Community trade; and (iii) viewing the criminal abuse of the system as a criminal activity and dealing with it as such and not as something that needs to be rectified by changing fiscal law.

Mr Arnold: If we look at the UK, if the current computer systems could cope within HMRC—and that is not a jibe but a serious point, because they are archaic, there has been a lack of investment—then we could look at the credit limit point that we have made to the Committee. We could also look at—a little like when you have a credit card—an authorisation system when you want to carry out a large transaction, but that would have to be in real-time. It is no good writing off or having to write off and hear back a month later: because you are a business, you want the answer as to whether you can go ahead in 15 seconds—which is what the credit card companies do when you are standing in the shop. We could do that. Thirdly, as we have said in our paper, we could do more to control the transfer of ownership of the business or the activity of the business and have a reporting requirement on that. We are very conscious
about continually transferring the burden to taxpayers or to businesses because then you create costs and you create a distortion in the way business is done. If we had the One Stop/27 Stop Shop, we would see a reduction in intra-Community trade and we would see an increase in imports, because businesses would route those out of the Community and back in in order to avoid the risks of the system. But that is a separate question.

Q193 Lord Cobbold: How can we persuade the politicians? How big a loss does it require before we can avoid this sticking plaster approach and concentrate on making some long-term improvement?

Mr Roy-Chowdhury: I think that is really a judgment call for politicians. When the origin system was being debated and discussed in the nineties, it was at the time of the convergence for the single currency. There was a real issue, probably as far as the UK was concerned, in terms of getting the money back out of the clearing bank system. Maybe there is less of that critical concern about the clearing bank now. With the amounts involved in MTIC fraud—if there is perhaps €100 billion across the European Union in fraud, a figure which is being bandied about—then is that enough? It is really a question for politicians. We also need a flexible system where different Member States can have their own rate of VAT. They can have their own zero rates, they can have their exemptions. All that was in the mix in the origin system debate before which made it untenable and unappealing for the UK, does not have to be. There was a political dimension at the Commission level at that time, looking at the origin system, which hopefully is less prominent now and so there might be a greater opportunity of looking at the origin system today.

Q194 Lord Cobbold: Presumably you would like this Committee to advocate a long-term solution. Do you think the origin system is still the best one to go for?

Mr Roy-Chowdhury: One that does not raise VAT levels, yes—which I think was the main concern before with the origin system and today we have more of a pragmatic, business-friendly environment.

Q195 Lord Cobbold: The computer system is not that impossible to create now. It is probably easier than it was a few years ago.

Mr Roy-Chowdhury: Quite. I entirely agree with that.

Mr Arnold: It is what the banks do every day of every month: release transfers of funds and so on. I think the missing voice in all these discussions has been business and how that can be aired. We are not immune to what is happening in the political world and we can see perfectly well the problems of an origin system in political terms. But if you are just looking at a business, perhaps a small/medium sized enterprise which gets an order for the first time, what is the easiest way in which they can do business with someone in another Member State? If you say, “In order to put the glass back into the window we will have to charge VAT,” the answer is clearly to them, “You have to charge VAT at the same rate as you charge it for a supplier within the UK—which you are already doing—and you account for it in the same way.” That is very easy for the business. It is not so easy for the state, because it then means that if you are going to transfer balances, which is another point, you have to have the clearing system. But if you are going to say to that business, “No, what you have to do is to find out the VAT rate in that other Member State”—and there are 26 of them—“make sure that VAT rate is up-to-date”—if you look at the paper from the Commission it is 37 pages long on VAT rates; some countries have three VAT rates for the same type of goods, so there are classifications within that, it is not broken down within that paper—and then invoice the VAT. Your invoice has to comply with the rules of that other Member State and you then have to pay that VAT—in the UK it will always be a foreign currency—to the tax authority in the other Member State. Depending on the law of that Member State, you could be held jointly and severally liable for the VAT if your customer does not account for it” then, quite frankly, the cost of finding this out and the cost of keeping up-to-date means that any sensible business or any sensible adviser would say, “What is the profit involved here? Don’t do it this way. Don’t do the deal.” You cannot load control after control after control on business without having a reaction. Larger businesses, you say, maybe can cope, but most computer systems cannot take another 27 VAT rates without major amendment—at least 27.

Q196 Lord Cobbold: Now you are saying it is too complicated to be realistic.

Mr Arnold: You could see that technically you could get an answer. You could see that possibly politically, if you got guarantees from Member States and the Commission kept an up-to-date register and that was binding on all Member States and so on, you might be able to have a system, but from where we are now that is verging on utopia. Charging VAT cross-border, if you are going to look at it from the perspective of the business, the only practical way is at the rate of the country you are in, rather than getting suddenly exposed to the tax systems of other Member States. It would be a complete nightmare if you got a Bulgarian assessment as a small UK business. How on earth do you start to deal with that? It is enforceable in the UK by the UK tax authority with mutual assistance. To use the words of my sons “you wouldn’t want to go there.”
Q197 Lord Cobbold: The reverse charge system would not work either.

Mr Arnold: The cross-border reverse charge system, as opposed to the domestic one. Effectively, the transitional system is a cross-border reverse charge and that is what is causing the problem. The domestic reverse charge does not help because of the conditions you have to meet in order to apply it. Even in the UK law, the 2006 law, we have one impossible and one almost impossible test for businesses to meet.

Q198 Chairman: This inquiry is now straying uncontrollably through long and short-term measures to fix it.

Mr Arnold: I am sorry, my Lord Chairman.

Chairman: Not at all. It is not your fault; it is the fault of the nature of the discussion.

Q199 Lord Inglewood: You could deal with a lot of the administrative problems which are the nightmare you have described by having a much more harmonised VAT system. I know in a different area the European Union is interested in the standard form for dealing with the import and export of works of art. If you had a standard European-wide set of rules with standard forms, you would in fact substantially mitigate a lot of the difficulties you have described, albeit there may be political problems. Is that correct?

Mr Arnold: Yes, provided the interpretation of the rules with standard forms, you would in fact substantially mitigate a lot of the difficulties you have described, albeit there may be political problems. Is that correct?

Q200 Lord Giddens: If you take these counter measures, how do you take account of the fact that innocent people are affected? One of the articles I read The Financial Times indicated quite difficult issues.

Mr Arnold: Perhaps I could comment on something Lord Steinberg said earlier. There are serious problems now being caused not only by the delays to repayments but by the VAT registration waiting list that can stop new businesses getting registered for up to five months while checks are made. That means, in reality, for a small business starting up, that you can invoice but you will not get paid until you have a VAT registration if your supplies are to other businesses. There are two reasons for that: either the business cannot process it without the VAT rate and everything through its own IT system or, secondly, the business chooses not to pay because it does not want to make an interest-free loan to government (because it cannot reclaim the VAT). It does mean that a start-up business, if they are unlucky enough, can be told by the state, “Okay, but you are not going to have any income for the first five months because that is the time it takes for us to let you join the VAT system.” It is causing all kinds of stresses and strains on innocent businesses. We accept you have to have checks—of course you do. We accept, if you have a repayment claim, that you have to have checks if the figure is out of the ordinary, but we think the delays are causing damage to business. If they are necessary to the state for the protection of the state, then we should be looking at ways to compensate business whilst those delays are taking place.

Q201 Lord Giddens: How could you resolve that? That seems to be at the structural level. If you are going to try to do something about this then you are bound to affect innocent traders, are you not?

Mr Arnold: We can talk about friendly fire and collateral damage, and the Paymaster General was quoted a few weeks ago as saying “It is better for the innocent to wait than for the guilty to get paid” but, if the result is that the innocent’s business fails—It is a question of balance. One can say, reasonably, maybe two weeks, maybe four weeks, but when you start getting on to repayments for a year with nothing you would need very good evidence as to why it is taking so long. There may be good reasons for it, but then you say: “If it is going to take that long, maybe we, the state, should be compensating the taxpayer”—not by making the repayment, because that is the point in question, but maybe we should be paying interest as they go along.

Q202 Lord Giddens: Maybe the economic consequences are more than the fraud.

Mr Arnold: In that case, do not hold on to the money for so long. I am an accountant. I like to see profit and loss accounts. I would love to see a profit and loss account of the options, of what the real figures are, how much it is costing business, how much it is costing the state, and then you could take a sensible decision. At the moment we are in this kind of fog.

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the Advocate General has just delivered an opinion, Teleos, in which some of these questions are going to be considered, so that may well give some guidance to this Committee in taking a view as to the issue of joint and several liability. But at the moment it is not clear. 

Chairman: It interests us because we are going to be seeing some of the people who may or may not be innocent traders—certainly people who have cases waiting. 

Lord Steinberg: I want to take up a point that Mr Hayes made about setting up a taskforce of senior inspectors to have a determined effort to try to get hold of some of these Mr Bigs that we have talked about. When I was in business, which was very recently, we used to have quite a bit of fraud occasioned both by staff and customers. We “rattled the cage”: in other words, we got a team of people together and really clamped down on the area where we thought a fraud had been committed. That stopped that fraud, not permanently but for a time, and so I was taken by what you said about getting a taskforce together. I wonder whether it is politically possible to do so. Is there any other country that we could look to that employs a better system than that which we currently use in the EU? For example, the American sales tax has been mentioned, but is there another area to which we can look to try to replace this system which obviously leaks like a sieve in so many areas? How does HMRC balance the need which has been already mentioned for monitoring transactions and not affect the normal trader? 

Q203 Chairman: Could I put a supplementary to that. At an earlier stage, in response to Lord Steinberg’s question, you suggested that the answer lay within SOCA. Does SOCA have to be Europe-wide? We have one. Does everybody else? It would really have to be not just us but everybody. 

Mr Hayes: I do not think so. If you are looking at criminal investigation, SOCA would be able to access Interpol and the other anti-criminal forces in other countries. I would probably be supportive of the idea of SOCA being tentatively extended throughout the Commission specifically to deal with this because that would give it the necessary powers to pursue without necessarily the need to liaise all the time. It is the liaison that is one of the difficulties because that takes time. 

Mr Roy-Chowdhury: In terms of other avenues to look at in terms of sales tax, the German wish for their derogation is virtually a sales tax, so clearly it is already on the table in a number of Member States or considered in a number of Member States to look at other than the VAT system. Maybe, if there is no political will to go to an origin system or a single VAT system in Member States, we need to look at more of a sales tax type system. 

Q204 Lord Cobbold: How big a change politically would that involve? 

Mr Roy-Chowdhury: Certainly the UK had a purchase tax. Australia had a sales tax. These things, historically, have existed. It has been a part of the requirement to join the European Union that everybody signs up to a VAT system because of the self-auditing and everything else. In terms of the politics, yes, I think it would be a big hurdle for some Member States, especially the French who invented VAT, to go that way, but I think it is something that needs to be in the mix. If we are not willing to get together with other Member States and devise a single system and a harmonised system, then perhaps we need to look at ways of dispensing with VAT entirely as a sales tax system for the European Union. 

Mr Arnold: The difficulty with a sales tax—which is not to counter it, but there are a lot of factors one has to look at—is, firstly, that you only have one stage of taxation, so as a tax authority or administration your risk is with that one business: VAT has a fractioned payment and repayment system, so you are spreading your risk. Secondly, you need a system of exemptions within a sales tax system, otherwise you will have a cascade effect on business-to-business sales that are then sold on. You end up probably with something not too different from a VAT system in the way it is operating, although you do not have the fractioned payments but you have exemptions. Whenever you have exemptions, you have a tax gap, which is precisely the problem we have now in cross-border sales. This is where you give the opportunity for the fraud. 

Q205 Lord Watson of Richmond: I would like to stick with this sales tax question for the moment. I was interested in your reference to the French having invented VAT and I think that is no small matter, as a matter of fact, because the French are really keen to hang on to what they believe they have contributed in the first place. The streamlined sales tax system in the United States, which I have met commercially—and I have to say I have been rather impressed by its operation—I would like to know your view of that particular tax and how it is working. 

Mr Arnold: It varies from state to state and some states do not have it at all, like New Hampshire.

Q206 Lord Watson of Richmond: Absolutely. 

Mr Arnold: It applies really to goods and not to services.

Q207 Lord Watson of Richmond: But there is nothing inherent— 

Mr Arnold: There is nothing inherent about that. They then have the problem of cross-border supplies, which we would have as well. They solved that in the
States by having an amnesty of no sales tax cross-border.

Q208 Lord Watson of Richmond: Admirably pragmatic.
Mr Arnold: Admirably pragmatic but I suspect that any chancellor would be a little reluctant to adopt that approach here in the UK. Of course it is at significantly lower rates in the States, anyway.

Q209 Lord Watson of Richmond: You do not really see it as a model.
Mr Arnold: I do not personally see it as a model.

Q210 Chairman: It involves a trusted third party intermediary?
Mr Arnold: I am afraid—

Q211 Chairman: Does anybody have a view on this?
Mr Hayes: If one looks at what is happening in America, you have a situation where each state determines whether or not it has a sales tax or a tax on services—some do, some do not. You have significant problems in the States agreeing on how cross-border transactions shall be dealt with—a major, major problem. If you were to change the VAT system in Europe into a sales tax system, yes, the headline rates would have to come down substantially to take account of the input sales tax that would not be recoverable. I think the point John makes is absolutely true, though, that, where you get a company like General Motors which will manufacture in 12 different countries within the Community and will move goods around, how does it deal with that? That is one of the things that a VAT system does cater for. Politically, to move to a sales tax within Europe would be far more difficult than seeking to move to an origin system, not as originally proposed—and I realise this is coming into another question—but as could be modified. I note that this Committee takes written submissions after evidence. As a result of our discussions, we will be putting in a short paper on this to you. We are not terribly agreed on this, I would add.

Q212 Chairman: I do not think it matters.
Mr Hayes: There is one view, which I have, that we should marry the VAT system far more closely to the direct tax system within the Community. For direct taxes, if you have Company A in the UK selling to Company B in Germany, the profit arising on the activity of Company A is taxed in the UK; the profit arising on the subsequent activity on those goods in Germany is taxed in Germany with the costs from the UK being a deduction. The fundamental problem with the origin system is that, under the proposal, all VAT will be charged in country and there will be no credit in the other countries. In my example, the UK would charge VAT and there would be no credit for that in Germany, which would mean that within the Community as a whole there would be a need for the establishment of a clearing house system. To some extent, that was trialled in the system that was set up for digital supplies in respect of supplies outside the Community, and it did not work—which is why I do not think there is much support within the Community for some form of clearing house system and why within the proposals for the One Stop Shop it is proposed that payments will be made directly from the trader to the individual company concerned. I take the view that within the system there should be a charge for VAT as goods go from one country to the other and that VAT rests within the country from which the charge goes but that the country that receives it should allow a credit against that. If I sell to you in Germany, I sell to you at £100 plus VAT at 17.5 per cent. You then, in Germany, sell on for £120 and you would charge German VAT at 19 per cent. You would allow a credit for the UK VAT at 17.5 per cent—and I accept that within this there is a foreign exchange issue, but I do not think that is insuperable. In Germany you would get all the VAT attributable to the profit element that you make in Germany. You would also get a small margin VAT and the difference between the two rates of VAT in Germany and the UK. If you used a supplier from Sweden to the UK, as an example, that would work around the other way and there would be scope for abuse by selling out from Sweden and out of the Community and then importing into the UK so that you do not have 25 per cent VAT charged into the UK in respect of a supply from the UK which was 17.5 per cent.
Mr Arnold: I think that over complicates it.
Mr Hayes: Perhaps that does.
Mr Arnold: I would say that the other aspect is that there is then no payment between the Member States. It is just the businesses themselves which are accounting for this. Obviously there will be controls but you would not need the clearing house.
Mr Hayes: More particularly, the individual transaction determines the amount of the VAT which goes into which Member States on the basis of supply. Where we know that within Member States transactions between countries are looked at and are continually being looked at for transfer pricing purposes, then there is a guarantee—or at least a degree of confidence—that the figures that will be used are more or less going to be commercially viable, so that you could not say that one state, for example Germany, is going to complain that they are not getting enough VAT. Similarly, the UK cannot complain because they have had VAT on a bit of the transaction that relates in the UK. That is the bones of a paper we are going to put forward to you.
Q213 **Chairman:** Do you know when you are going to be able to produce this paper? Will it be within the time of the inquiry?

**Mr Hayes:** When does your inquiry complete?

Q214 **Chairman:** Around Easter, I think.

**Mr Hayes:** Certainly within the next three weeks you will have it.

**Chairman:** That would be most helpful. Between us, we have managed to ask just about everything I wanted to ask, with the exception, Lord Jordan, of your question about the short-term issue.

**Lord Jordan:** The reverse charge.

**Chairman:** Yes, on particular goods.

Q215 **Lord Jordan:** I am hesitant to ask it because I think we are in the world of Lewis Carroll here actually. I know that, whatever we say, there will be another 10 outlets but it has been suggested to us that if particular industries are targeted with reverse charge solutions then the fraud would move to other goods. Is there evidence that this has happened when changes have occurred before?

**Mr Arnold:** We are told there is evidence that has happened and it would seem logical for it to happen. It is why, although we proposed it—we were by no means the only ones—in 2003, we now have a big question mark as to whether the UK should get the derogation that it has requested. Because if there is going to be a derogation, if there is going to be a reverse charge procedure, we feel it should be consistent across the whole of the European Community. We do not mind if it is the UK reverse charge that is requested¹, but we do not want to see different provisions in each Member State. That makes it very difficult for business. The German reverse charge has some logic to it in terms of combating fraud because it goes right across the board. But, once again, it puts a high compliance burden on all businesses because they have to file invoice listings, et cetera. There is compliance weariness and a feeling of over-regulation now, without adding to it. The UK reverse charge is likely to cause a shift in the type of goods used in the fraud, quite frankly, and there is some evidence I have heard that it has already shifted in anticipation of the UK getting it.

**Mr Roy-Chowdhury:** That is right. In southern Europe, as I mentioned, it is these high-value vehicles and razor blades. The shift is going to happen. One other aspect we have not touched on, which I think is a German idea—which I do not advocate—is where you marry up the input tax and output tax before you make a repayment. I think that is going to be extremely onerous on businesses. I really flag that up because we want any proposals going forward to be business friendly. I know the Germans did tout this idea around. It would cause extreme difficulty in terms of cash flow and I think the IT systems as well within Member States would not be able to cope.

Q216 **Lord Jordan:** This means you cannot reclaim the input tax until you have paid the output payment.

**Mr Roy-Chowdhury:** Yes. You would marry up the transactions all the way along.

Q217 **Lord Steinberg:** What do you think about my suggestion of firing a warning shot across the bows of these criminals by rattling the cage in getting this through? How practical is it and how quickly could it happen?

**Mr Hayes:** I think it is something that should happen. I think it is desirable. I can give you an example of a case of which I am aware. I was consulted by a firm of auditors with a client who had turnover going from zero to about £20 million in two years. The business had not introduced any capital. It used the Netherlands Antilles bank that I was referring to. It had 14 transactions and it was now taking HMRC to judicial review for the repayment of £1.5 million VAT. The balance sheet of the company was £1.5 million, represented by £100 share capital and retained profits of £1.5 million. John said to me yesterday, when I told him about it: “Have they proposed a dividend?” I said, “Not yet.” How much more circumstantial evidence do you need of what is going on? There are no price lists; payments are not made until sums are received; all transactions go through one bank—but that business is not being dealt with as a criminal activity, it is being dealt with within the tax system. That, to me, is *Alice in Wonderland.*

Q218 **Chairman:** It remains for me to thank you all very much. It has been a most useful session. We look forward very much to your paper because that will move us on. The theory tends to float above us and a paper saying exactly how something might work would be extremely useful to this Committee. Thank you very much.

**Mr Arnold:** Thank you. I am not sure how much we have helped. But I hope—to use the quote—we have left you “confused at a slightly higher level”.

¹ *Note by Witness:* Whilst supporting the concept of a reverse charge as one of the temporary measures that could help to reduce MTIC fraud until a more lasting solution is in place, the ICAEW do not consider that the specifics of the reverse charge requested by the UK are either proportionate or acceptable.
Supplementary memorandum by the Institute of Chartered Accountants in England and Wales

INTRODUCTION

1. The ICAEW submitted evidence to the Committee in October 2006 and in January 2007 (not printed).
2. This paper follows on from the Oral Evidence to the Committee given by Mr John Arnold and Mr Ian Hayes of the Institute of Chartered Accountants in England and Wales, and in particular the evidence of Ian Hayes at Q.212–214.
3. The context of this paper is that the charging of VAT on cross-border supplies would eliminate the opportunity for carousel or MTIC fraud.

CHARGING VAT ON CROSS-BORDER SUPPLIES—A REVISED ORIGIN SYSTEM BASED ON LOCAL CONSUMPTION

4. Pre the 1993 Single Market VAT changes, the Commission had proposed a “pure” origin system, under which businesses would charge VAT at their domestic rate and account and pay that VAT in their own currency to their own tax authority. Member States would have to use a clearing system for the balances, either bilaterally or through a central clearing house run possibly by the Commission. Whilst a “business-friendly” system, it was rejected by the Member States, principally because they were not prepared to accept the clearing house system.

5. An alternative solution, which would avoid the need for any clearing house, would be to allow the tax charged on a cross-border supply by a business in one Member State (MS1) to remain in that Member State.

6. So a business in MS1 selling goods to a business in another Member State (MS2) would charge VAT at the normal rate for MS1 and account for the VAT due to the tax authorities in MS1. The business customer in MS2 would pay that “foreign” VAT to his MS1 supplier, but would be entitled to deduct it as input tax in his MS2 VAT Return. When he sold on to a customer in MS2, he would in effect charge VAT on the balance. The process can be illustrated by a simple example, where a UK business sells standard-rated goods to a business in the Netherlands, who on-sells them to a Dutch customer.

<table>
<thead>
<tr>
<th>Net</th>
<th>VAT</th>
<th>Total</th>
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<tbody>
<tr>
<td>(i)</td>
<td>UK coy sells €100 of goods to Dutch coy</td>
<td>€100</td>
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<td></td>
<td>UK coy accounts for €17.50 VAT to HMRC in his UK VAT Return.</td>
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<tr>
<td>(ii)</td>
<td>Dutch coy sells goods to Dutch customer for €120 (Dutch VAT standard rate 19 per cent)</td>
<td>120</td>
</tr>
<tr>
<td>(iii)</td>
<td>Dutch coy accounts to Dutch tax administration in his Dutch VAT Return—output VAT charged less input VAT</td>
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<td></td>
<td>Net payable</td>
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7. So VAT totalling €22.80 is still charged on the final supply, of which the UK Treasury would receive €17.50 and the Dutch Treasury €5.30.

8. The advantages are:
   — As with the “pure” origin system, a business only has to apply the system he knows and understands in his own MS, and deal with his own tax authority.
   — Since positive VAT rates will be charged on sales, the scope for carousel fraud on intra community trade is severely reduced, if not eliminated.
   — The tax administration in MS1 will receive the VAT due on the first sale at MS1’s normal VAT rate.
   — The VAT and direct tax treatments will be similar, helping both business risk evaluation and any tax audit.
   — The trading activity itself will determine the allocation of revenue between MSs.
30 January 2007

9. There are however some disadvantages:
   — Whilst it will not affect the total VAT due, the system will affect revenue allocation between Member States. Each MS can be expected to calculate whether it would be a “winner” or a “loser”. But that has to be set against the cost of operating (ie not having to operate) a clearing house.
   — The system will need to cater for the problem of exchange differences.
   — The system will need take account of the differential rates of VAT applied throughout the EU.
   — It would create the opportunity for other tax frauds, such as fake invoices, but these would be less dangerous, and easier for tax administrations to counter, than MTIC fraud.

10. A variation on the above suggested by the Commission and others is the use of a single VAT rate for intra-community trade. We believe this suggestion has merit since it will allocate revenue on intra-community trade without the distortion that arises from different rates. If the rate were the lowest permitted standard rate (currently 15 per cent), every MS would receive tax on intra-community sales at that rate and (leaving aside zero-rated or lower rated items), would never have to give a credit for “foreign” input tax in excess of that charged by the supplier in their own Member State.

11. To simplify the exchange rate issue, the Euro could be the currency of accounting with published exchange rates to be applied in all non-Euro Member States.

23 February 2007
TUESDAY 6 FEBRUARY 2007

Memorandum by HM Treasury and HM Revenue and Customs

Q1. What is the exact nature of VAT Carousel Fraud?

Missing Trader Intra-Community (MTIC) VAT fraud is an organised criminal attack on the VAT system, which is estimated to have cost the UK exchequer between £1.1 billion and £1.9 billion in stolen VAT revenues in 2004–05. Its simplest form—known as acquisition fraud— Involves obtaining a VAT registration number in one Member State for the purposes of purchasing goods free from VAT in another EU Member State, selling those goods at a VAT-inclusive purchase price in the UK and then going missing or defaulting without paying the VAT due to HMRC.

A more abusive form of the fraud—known as carousel fraud—involves the same goods being traded around contrived supply chains within the EU, and re-entering the UK on a number of occasions with VAT being stolen each time. A simple example is:

— Company A in another Member State sells goods VAT free to a UK company B.
— Company B sells the goods VAT inclusive to another UK company C.
— Company B should pay the VAT it has charged on the goods to HMRC, but fails to do so. Instead they go missing, or default on the payment.
— Company C sells the goods VAT free to an EU or third country company, which could be company A (hence the term “carousel”). Company C claims the VAT it has been charged by company B from HMRC.

The fraud occurs when company B does not pay the VAT, and the tax loss crystallises when company C claims a VAT repayment from HMRC. In practice the fraudsters complicate this model by inserting a number of other companies in contrived transaction chains between companies B and C, and routing the goods out of the EU. In the UK the goods most commonly associated with this fraud are mobile phones and computer chips, but other (particularly electronic) goods have also been targeted recently.

Q2. Are there gaps in legislation which allow this form of fraud?

EU VAT law is set out in the Sixth VAT Directive (Directive 77/388). This legislation is clear that sales between registered traders in different Member States are normally VAT free, and VAT is charged on subsequent sales within the Member State. The fraudsters exploit these rules by charging VAT and illegally failing to pay it over to the Government, while abusing the right to deduct VAT on their purchases. MTIC fraud therefore does not occur because of gaps in legislation, rather it involves criminal breaches and abuses of the law.

Q3. What impact does this fraud have on the internal market?

Simple acquisition fraud can lead to market distortions because the fraudster, who has no intention of paying VAT, is able to undercut legitimate businesses trading in the affected markets. Carousel fraud often involves over-valued supplies, but the impact on the legitimate markets for the goods involved is relatively small because of the closed nature of the contrived transaction chains operated by the fraudsters. However, the very scale of the fraud can damage public finances, distort trade statistics, and disrupt the timely delivery of new products to the retail market. Whilst many Member States do not publish the scale of losses in their particular jurisdictions, MTIC fraud is recognised as a common problem and it is clear that losses from this type of fraud are experienced throughout the EU.
Q4. What are the measures currently applied to combat this fraud and what are their weaknesses?

HMRC’s strategy for tackling MTIC fraud has been in place since September 2000. It aims:

— to stop the fraud before it can begin through risk based controls to identify bogus businesses and refuse to register them for VAT purposes;

— where fraudulent trading begins, to identify and stop it at the earliest opportunity—by operating close audit and verification controls on suspect businesses and those trading in affected sectors; and

— where it cannot be stopped, to disrupt the fraud—by tackling all points of the supply chains and using the full range of criminal and civil measures available to target those orchestrating and/or facilitating the fraud. HMRC works closely with UK agencies and overseas agencies to identify and target suspect trading and money flows.

As the patterns of fraud have changed, HMRC has adapted and strengthened its MTIC strategy accordingly, key changes being:

— redeploying almost 600 additional compliance officers to verify repayment claims submitted by those trading in suspect supply chains;

— strengthened international co-operation both with EU Member States and with non-EU countries;

— introducing legislative measures in this year’s Finance Act to clarify and strengthen UK powers to tackle MTIC fraud; and

— applying to the European Commission for a derogation to introduce a reverse charge accounting procedure for the goods most commonly used in MTIC fraud.

The reverse charge would effectively remove the physical payment and repayment of VAT from business-to-business transactions, thus removing the opportunity to steal VAT. The derogation is subject to adoption by the Commission and Council. Based on current progress with the derogation process, HMG expects to implement the reverse charge on 1 December 2006.

The main challenges for HMRC’s strategy are the speed with which the fraudsters can change their tactics in response to HMRC interventions, and their ability to disguise their activities to resemble legitimate trading. This requires HMRC’s strategy to be very flexible, finding a balance between effectively targeting the relatively small number of fraudsters, while minimising the impact of that activity on the vast majority of the 1.8 million VAT registered businesses who trade legitimately within the UK, and acting within the constraints of EU and UK law.

Having good and timely intelligence about those involved in the fraud and their tactics is the key to getting this balance right. It is important for the UK to continue to share intelligence and work with our EU partners to tackle the fraud.

Q5. Are the mechanisms suggested by the Commission to fight this fraud adequate?

The Commission has advocated several approaches to combating carousel fraud, from strengthening existing practices regarding mutual assistance, to more fundamental changes to the VAT system, which could involve either a move to the Origin system, a reverse charge option, or a single rate of taxation for intra-community trade.

The recommendation to improve EU mutual assistance is to be welcomed. This would be achieved at a number of levels, including improvements to the IT infrastructure to exchange information and better application of procedures contained in existing legislation that are currently under-resourced. The Commission has prepared provisional plans to upgrade the IT infrastructure but the draft timetable indicates delivery during the period 2009–11. The UK is making every effort to speed up delivery.

The suggested move to an Origin system, where VAT is charged in the Member State of the supplier, has a number of problems. Not only could it lead to a harmonisation of VAT rates, as businesses would relocate to the Member State with the lowest rate of VAT, but also new fraud opportunities could be created by the cross-border nature of the supplies. These fraud opportunities would also arise with a single rate taxation of intra-community trade.

The Government is interested in exploring the technical feasibility of other legislative measures to counter VAT fraud at the EU level, including reverse charge measures and other options not specifically mentioned by the Commission, such as enhancing Member States’ ability to refuse repayments in cases of fraud.
6 February 2007

Q6. *Are Member States, within the context of the Internal Market and the Globalised Economy, capable of fighting individually against this fraud or is it right for the Commission to bring forward proposals on their behalf?*

The answer to fighting carousel fraud is through a range of solutions both domestically and at EU level. The UK is already making progress through its package of measures, which address the fraud throughout all the stages in the supply chain. In addition we hope that the Commission and Council will soon adopt a proposal which would allow the UK to derogate from Community VAT law, and introduce a domestic reverse charge for the specific goods targeted by the fraudsters. However we also welcome the Communication from the Commission on VAT fraud and support many of the measures suggested, in particular the need to improve mutual administrative assistance. Whilst we would not be in favour of all of the policy responses suggested in the Commission’s Communication, we welcome the opportunity to discuss these issues, including how to strengthen the ability of Member States to combat fraud through changes to the Sixth Directive and improvements in the practical application of existing legislation where co-ordinated action is required.

Q7. *Does the adoption of measures to fight VAT fraud at the Community Level undermine Member States’ control over the functioning of National Fiscal Systems?*

The majority of measures suggested by the Commission would improve Community legislation and procedures that would support and enhance the ability of Member States to combat fraud. The UK will oppose any move to the Origin system that would undermine the basis of VAT as a consumption tax and will look carefully at all suggested solutions to ensure that they do not undermine the functioning of national systems.

21 September 2006

**Supplementary memorandum by HM Treasury and HM Revenue and Customs**

Q1. *What impact does this fraud have on the Internal Market?*

Missing Trader Intra-Community (MTIC) VAT fraud is an organised criminal attack on the EU VAT system. The simplest form of the fraud—known as acquisition fraud—involves obtaining a VAT registration number in one Member State for the purposes of purchasing goods free from VAT in another EU Member State, selling those goods at a VAT-inclusive purchase price in the UK and then going missing or defaulting without paying the VAT due to HMRC. Simple acquisition fraud can lead to market distortions because the fraudster, who has no intention of paying VAT, is able to undercut legitimate businesses trading in the affected markets.

A more abusive form of the fraud—known as carousel fraud—involves the same goods being traded around contrived supply chains within the EU, and re-entering the UK on a number of occasions with the aim of creating large unpaid VAT liabilities and fraudulent VAT repayment claims on each occasion. This often involves over-valued supplies in order to maximise the VAT involved, but the impact on the legitimate markets for the fraud is relatively small because of the closed nature of the contrived transaction chains operated by the fraudsters. However, the very scale of the fraud can damage public finances and distort trade statistics owing to the fact that the same goods in a carousel are recorded each time they leave the UK artificially inflating UK exports. In addition, carousel fraud can disrupt the timely delivery of new products to the retail market as these are used within the carousels. Whilst many Member States do not publish the scale of losses in their particular jurisdictions, MTIC fraud is recognised as a common problem and it is clear that losses from this type of fraud are experienced across the EU.

The Government estimates that the scale of attempted fraud against the UK in 2005–06 was between £3.5 billion and £4.75 billion, with an estimated negative fact on the VAT receipts during the year of between £2 billion and £3 billion.1

Q2. *What are the measures currently applied in the UK and other Member States to combat this fraud and what are their weaknesses?*

HMRC’s strategy for tackling MTIC fraud has been in place since September 2000. It aims:

— To stop the fraud before it can begin by introducing risk based controls to identify bogus businesses and refusing to register them for VAT purposes;

1 Bond House *et al*, joined cases C-354/03, C-355/03 and C-484/03.
BEGINgne:

Where fraudulent trading begins, to identify and stop it at the earliest opportunity—by operating close audit and verification controls on suspect businesses and those trading in affected sectors; and

Where it cannot be stopped, to disrupt the fraud—by tackling all points of the supply chains and using the full range of criminal and civil measures available to target those orchestrating and/or facilitating the fraud; and by working closely with UK and overseas agencies to identify and target suspect trading and money flows.

As the patterns of fraud have changed, HMRC has adapted and strengthened its MTIC strategy accordingly, key changes being:

— redeploying almost 700 additional compliance officers to verify VAT repayment claims submitted by those trading in suspect supply chains;

— strengthened international co-operation with both EU Member States and non EU countries;

— introducing legislative measures in last year’s Finance Bill to clarify and strengthen UK powers to tackle MTIC fraud; and

— applying to the European Commission for a derogation to introduce a reverse charge accounting procedure for the goods most commonly used in carousel fraud.

The reverse charge would effectively remove the physical payment and repayment of VAT from business to business transactions, thus removing the opportunity to steal VAT. Following the UK’s application for a derogation from Community VAT law, the European Commission has come forward with a corresponding proposal, which is subject to adoption in the Council, by unanimity. Discussions are ongoing, but the Government expects to implement the reverse charge eight weeks from formal agreement.

The main challenges for HMRC’s strategy are the speed with which the fraudsters can change their tactics in response to HMRC interventions, and their ability to disguise their activities to resemble legitimate trading. This requires HMRC’s strategy to be very flexible, finding a balance between effectively targeting the relatively small number of fraudsters, while minimising the impact of that activity on the vast majority of the 1.9 million VAT registered businesses that trade legitimately in the UK.

Having good and timely evidence about those involved in the fraud and their tactics is the key to getting this balance right. It is important for the UK to continue to share intelligence and work with our EU partners and the European Commission to tackle the fraud. HMRC is hosting a conference of EU partners on 21 February, aimed at strengthening the arrangements for sharing such intelligence in support of both criminal investigations and civil interventions.

The measures currently used by the UK to combat MTIC fraud are also available to all other Member States, and will be used in proportion to the scale and nature of the attack that each State faces.

Q3. The Commission has suggested measures including increased cross-border liaison by Tax and Law Enforcement Authorities and Governments, improved risk management, and mutual assistance by Member States wishing to recover unpaid taxes. Are these mechanisms adequate?

The recommendation to improve EU mutual assistance is to be welcomed. This would be achieved at a number of levels, including improvements to the IT infrastructure to exchange information and better application of procedures contained in existing legislation that are currently under-resourced. There is also a need to look more closely at the overall quality and speed of VAT information that is currently exchanged to ensure there is greater focus on more rapid and direct exchanges in high risk areas. A small Member State project team to look at this issue is in the process of being created, and the UK welcomes this positive step.

The Government is determined to tackle MTIC fraud, and for this cooperation at a European level is vital. However, it is important for Member States to explore the full range of options including measures such as a reverse charge or the taxation of intra-community trade, along with other options not specifically mentioned by the Commission, such as enhancing Member States’ ability to refuse repayments in cases of fraud.
**STOPPING THE CAROUSEL: MISSING TRADER FRAUD IN THE EU: EVIDENCE**

*6 February 2007*

Q4. *Are Member States, within the context of the Internal Market and the globalised economy, capable of fighting individually against this fraud or is it right for the Commission to bring forward proposals on their behalf?*

MTIC fraud is an EU wide problem which can only be tackled through a range of solutions, both domestically and at EU level. Member States need the flexibility to deploy their resources and domestic tools in proportion to the nature and scale of the attack that they are facing. The UK is already making progress through its package of measures, which address the fraud throughout all the stages in the supply chain. In addition we are confident that the Commission and Council will soon adopt a proposal which would allow the UK to derogate from Community VAT law, and introduce a domestic reverse charge for the specific goods targeted by the fraudsters. However, we recognise that tackling the fraud requires EU wide cooperation, and as such we welcome the ongoing discussions within the EU following the production of the Communication from the Commission on combating tax fraud, and, in particular, support the need to improve mutual administrative assistance. We also welcome the opportunity to discuss ideas based on strengthening the ability of Member States to combat fraud through changes to EU VAT law and improvements in the practical application of existing legislation where co-ordinated action is required.

Q5. *Is it necessary to simplify or restructure the VAT System to prevent this type of fraud? If so, how might this be done?*

The EU VAT system benefits many millions of businesses and consumers, and the basic rules—that sales between registered traders in different Member States are normally VAT-free, and VAT is charged on subsequent sales within the Member State—are well understood and properly applied by the vast majority of businesses both within the UK and across the EU. MTIC fraud is an organised criminal attack on the VAT system. It is important that any measures to tackle that threat are properly targeted at those orchestrating or facilitating the fraud and the methods that they use. Anti-fraud measures should not undermine the benefits of the Single Market.

Q6. *Does the adoption of measures to fight VAT fraud at the Community level undermine Member States' control over the functioning of National Fiscal Systems?*

The Commission has put forward several approaches to combating carousel fraud, from strengthening existing practices regarding mutual assistance, to more fundamental changes to the VAT system, which could involve either a move to an origin system, a reverse charge option, or a single rate of taxation for intra-community trade. Several of the measures suggested by the Commission would improve Community legislation and procedures, which would support and enhance the ability of Member States to combat fraud. However, the UK will oppose any move to an origin system that would undermine the basis of VAT as a consumption tax, and will look carefully at all suggested solutions to ensure that they do not undermine the functioning of national systems.

Q7. *What would be the benefits and costs of moving from the current destination system to an origin system?*

The suggested move to an origin system, where VAT is charged on all goods and services in the Member State of the supplier, has a number of problems. Firstly, to prevent businesses relocating to the Member State with the lowest rate of VAT, an origin system would necessitate a high level of harmonisation, not only of the VAT rates themselves, but also to the basic elements, such as input tax rules. This would seriously undermine the ability of Member States to set rates and rules in accordance with their own social and economic needs, and in the UK would present a direct threat to our zero rates. Many Member States have long recognised this threat to their sovereignty and, coupled with the necessity for a pan European revenue redistribution mechanism which would itself present enormous technical and practical challenges, would reject any move to an origin system.

Secondly, new fraud opportunities would be created by the cross-border nature of the supplies. These are the opportunities that would arise with any taxation of intra-community business-to-business trade, whether charged at the rate of the Member State of the supplier, the purchaser, or at a single pan European rate. It is the task of the Commission and Member States to arrive at a practical solution to MTIC fraud that minimises new fraud opportunities.

*16 January 2007*
6 February 2007

Examination of Witnesses

Witnesses: Rt Hon Dawn Primarolo, a Member of the House of Commons, Paymaster General, Mr Mike Eland Director General of Law Enforcement HMRC, and Mr Richard Brown Head of International Indirect Tax HM Treasury, examined.

Q219 Chairman: Minister, if I may formally welcome you to this inquiry and thank you very much for coming to help us. May I also formally welcome the rest of the audience. I am always pleased to have an audience. You know the rules, Minister. All this is being recorded and you and your officials will receive a copy of the transcript and have an opportunity to comment on it. That being said, we have sent you a lot of questions, some of which are based on previous evidence given by your officials. Do you want us to start by asking the questions or would you, or either of your officials, like to make an opening statement?

Dawn Primarolo: Thank you very much. I did have a short opening statement but, to be perfectly frank, I think the Committee is quite well appraised of the challenge we face and you are aware of the steps we have taken. It is probably best if I just introduce the two officials who are sitting alongside me and then I will be happy, between the three of us, to answer as many of your questions as we are able to today and, if not today, in writing subsequently. Can I introduce Richard Brown, Head of International Indirect Tax in Her Majesty’s Treasury, and Mike Eland, the Director General of Law Enforcement in Her Majesty’s Revenue and Customs.

Q220 Chairman: May I start off with the first question. One of the things we are having difficulty getting a handle on is do you think that missing trader fraud is a bigger problem in the United Kingdom than in other European countries or are we better at detecting and measuring it?

Dawn Primarolo: It is inconceivable that other Member States are not the subject of this type of fraud as well. We know, for instance, that both Germany and Austria have been very vocal about their losses. Germany has said something like 3.5 billion EUR as an estimate and they are pushing for a full reverse charge. If we look at Spain, we have seen reported recently arrests in connection with a 300 million EUR carousel fraud. France has been subject to press reports as well about fraud in the region of 2 billion EUR. I think the position is that the UK identified this as a potential threat and therefore has been trying to quantify and publish statistics on the potential loss to fraud whereas other Member States, at the current time, do not choose to go down that route. Certainly in my discussions with European colleagues, finance ministers generally, particularly in the larger economics, were worried about the potential here because it is exploitation of the rules as opposed to clever interpretation or re-interpretation of the rules; it is outright theft.

Q221 Chairman: In talking to people we find it a little surprising that other countries do not actually publish the scale of their losses as we do. The last publication was in the autumn statement. Has anybody any view as to why other countries are not being as vocal about it as we are?

Dawn Primarolo: I am afraid I cannot answer why other Member States have not chosen to publish the figures in the same way. I think it is probably true to say, and Richard can correct me if I get this wrong, the UK started looking at the issue of the tax gap in VAT some considerable time ago. You may recall there was a big drop in our forecast against actual receipts back in 1996. There have been different times when forecasted receipts and what we actually received did not match, and following various inquiries, the last one being the Roques Report, the UK has been much more concerned to actually look at whether there is a tax gap, how large it is and what causes it. Therefore, that has informed not only our domestic policy but our response to things like unfair tax competition to try to understand what is going on there. I can only take an educated guess at that. I know other Member States are very defensive with regard to what is the scale of their loss. In some Member States it will be much harder because of the way it is constructed. In Germany, for instance, it is much more difficult to try and put a specific figure and measure on it.

Q222 Chairman: While we were in Brussels we talked to the Eurocanet people, which is a collaborative project between finance and anti-fraud agencies in EU Member States. We wondered why the United Kingdom had, by Eurocanet’s account, stopped participating in what they were trying to do.

Dawn Primarolo: This is quite a technical issue around the issue of third pillar and exchange of taxpayer information with competent authorities. I might ask Richard to supplement my answer. When Eurocanet started, the UK was one of five Member States participating, although the project was initially set up to look for missing traders which is slightly different to what we are pursuing, although complementary, to the question of missing money, fraud. Information was being exchanged and the nature of this information is often taxpayer information. The Commission subsequently decided they wanted to have an external partner, OLAF, who are not covered by our gateways or by the regulations.
to exchange taxpayer information. It was data that was being exchanged. It is not quite in this area because what we need to look at is who is committing the fraud, how they are committing the fraud, how we collect the evidence, how we prosecute and how we do that across different authorities. Eurocanet was never intended to do that. It may be useful in missing traders but not specifically on the fraud.

Mr Brown: One thing I would like to add to what the Minister said on this point is essentially Eurocanet, when it was set up, was a pilot study which was aimed at trying to identify missing or defaulting traders. It is fair to say that having participated in the experiment the HMRC took the view that they had better means available to them than the approach being taken by Eurocanet to identify missing traders more quickly. That was one of the main reasons why they took the view they were not going to continue with the exchange of information aspect of the project which was actually quite resource intensive as far as HMRC were concerned. In addition, there was Eurocanet’s concern about the involvement of OLAF because of our real concerns about giving out confidential taxpayer-related information to third parties who are, in our view, not legally covered by the gateways.

Q223 Chairman: It started out as a police operation in some sense, the Eurocanet; it was about finding some of these missing traders.

Mr Eland: That was how it initially started but it has moved on since into this other territory. There are the legal problems to which Richard has referred and also the costs of providing the information which has an opportunity cost when we have to divert effort from elsewhere. We are focusing our attention on identifying missing traders through using the information systems that we have and also third party information systems in the UK which we feel is a much more effective way of identifying traders in this area.

Q224 Chairman: We were slightly puzzled having met Eurocanet. I think you have given me the answer to the question whether this fraud is a concerted and sophisticated attack but perhaps not. Do you believe that this fraud is a concerted and sophisticated attack on the VAT system by organised crime or is it an opportunity that has been exploited by casual fraudsters?

Dawn Primarolo: Carousel fraud is an outright attack on the system. It is highly sophisticated, well informed, relies on very long chains. The whole series of frauds exploit an understanding of how we would have to collect evidence and follow the chain through. There would be casual, in the sense of one-off, repayment fraud which we are dealing with, and we would acknowledge that in that area it might be somebody who just gives it a go to claim back a lot of VAT and puts in fraudulent forms, but the carousel, which is the issue here, is most definitely organised. We will come back to it in the later questions but, for instance, the weekend before last I was in Dubai with regard to actions there in pursuing revenue which has been stolen and connections with criminal cases. It is quite clear that these are organised criminal gangs and all of the Department’s intelligence indicates that.

Q225 Lord Blackwell: I wonder if we could explore a bit more this question of information exchange and cross-border liaison and whether more could be done. Commissioner Kovacs told us that against the background of 35 million traders in intra-community trading there had been only 26,000 information exchanges between Member States and that that exchange of information is very slow in occurring. I guess the question we are interested in is whether better information exchange, recognising the difficulties you mentioned about protecting taxpayer information, would help tackle this fraud problem. What is currently going on to share information? Do you think there is more opportunity to develop that? In particular we understand there is a cross-border conference on the 23 February so what is it that you would expect to come out of that?

Dawn Primarolo: I will try and unpack all the questions and if I miss one please correct me. If we deal, firstly, with the question of whether the information exchange, at the present time, needs to be improved and speeded up, then the answer is yes. The United Kingdom is at the forefront of trying to press and improve, using this as our experience, the types of information and the speed at which it is exchanged. Clearly there are resource constraints on all Member States and there is an issue there. We currently exchange, both on criminal and civil, intelligence and information to identify fraudsters verifying returns, but we do need to do more. If we move on to the question you asked about the conference in February, which is again a UK initiative, across Europe not all tax departments have the investigation and enforcement abilities that HMRC have. There are very particular questions when it comes to exchange of this type of information as well. Sometimes, because of a separation between law enforcement and tax authorities, we may not be dealing directly with what would be recognised as our opposite numbers in Europe. Also those authorities may not necessarily have the powers or the remits to undertake investigations for tax fraud. What we need to explore, following on from your question, is not just about whether we are exchanging relevant information in a speedy way, although that is very important, but also about making sure that we are able to exchange, particularly on an evidence-base,
information coming back to the UK or flowing from the UK for prosecutions of cases elsewhere in Europe. We are very seized of that issue because we are needing to communicate with quite a range of authorities at the moment. What we are looking to try and get agreement to establish is, firstly, some sort of auditing to give us a base line. If we cannot do it individually, is there some way we might know the scale of the problem across the European Union? Secondly, there is the whole question of coordination, how we share that information and share it properly if we, or another Member State, are to have a successful prosecution. We do need to have further debate on exchange of evidence. The exchange of information and the mutual exchanges at the moment are not really facilitating that type of work—I will be tacit—as well as it should to enable cases, which are highly complex and spread across a number of Member States, to be prosecuted in any one. The answer is yes, but we need to put new points on the table. This question of evidence is crucial and I think the base line of the auditing as well.

Q226 Lord Blackwell: In getting the evidence and getting the information flows, are there legal barriers between the different States in terms of the way the laws interpret this, which have to be solved first or is it just a question of co-operation and willpower?

Dawn Primarolo: We believe the legal framework permits this but I am sure you will appreciate that other Member States, who might be concerned with regard to exchange, need to explore that more. For instance, on the 21 February conference what we are hoping to do, because we have been discussing outside the European Union with the Dubai authorities and we now have a Memorandum of Understanding with them about the flow of evidence which is much more complicated coming from quite different legal systems, is to demonstrate how this can be achieved and then try and explore within Europe. You will have seen reported, the Dutch authorities actually took action within their remit, on which we jointly worked with them, so they would be prosecuted in the Netherlands. There is quite a lot of discussion between the attorney generals about how that is facilitated.

Q227 Chairman: Just a supplementary on that, are we talking about getting the police of one country to give evidence in the courts of another?

Dawn Primarolo: I think not. It is about collection of evidence. I might need some support because I am not a lawyer. As I understand it, it is about actually having the evidence, how the evidence is collected and then transmitted.

Mr Eland: Exactly that. There will be occasions where we will ask the authorities of another country to ask some questions or to find out information, and obviously where that is concerned with a criminal investigation you have to ensure it fully follows rules of evidence and is properly gathered so it is then usable in the UK courts. It is making sure that process is properly followed through. In some cases it is simply just getting information about a company or something, it does not involve any intrusive powers, and that can simply be obtained in the normal way through the mutual assistance arrangements. There is usually little problem with that, it is more the criminal evidence that we have to be very careful about.

Q228 Chairman: That is one of the things making life difficult in prosecuting people who have committed crimes against the United Kingdom with that system.

Mr Eland: We have some very good operational relationships with a number of countries. They have assisted us in operations and we have done joint operations with them. We did a large scale operation just before Christmas which involved four other Member States all working simultaneously to carry out the operation. What we want to do through this conference is to share that practice and try and leverage it across a wider span of countries.

Q229 Lord Inglewood: What I would like to do is ask a few questions about the administrative approach to tackling the problem. I would like to break them down to bite sizes and if you could give me bite size responses we can move on. The starting point must be the recognition that an enormous amount of public money, figures have been bandied about of £2.5 billion, going walkabout and therefore it follows that whatever is being done now is not working successfully to deal with the problem. Is that fair?

Dawn Primarolo: I do not think it is fair. I agree with you the scale of the challenge of revenue that we believe was subject to fraud in the VAT system. What I would say to you is the arrangements we have in place now, or the evidence we have from trade statistics, show us that our current administrative arrangements are having a downward pressure to the point where it is now miniscule. There are reasons for how we came to be at the point we were before we changed our administrative response which is to do with legal cases. I fear I have gone on too long. I can tell you why I think our administrative practices work now and I have a view about how we came to be in a position where we needed to change our administrative patterns.

Q230 Lord Inglewood: The key point that emerges from that reply is you are saying to the Committee, by virtue of the recent changes in your administrative practices, you have, to use the word I use with a bit of care, cracked the problem?
Lord Inglewood: The current manifestation of this type of carousel fraud is being held in check by our current administrative arrangements. The challenge to the system will be whether our preparations and our risk assessments hold if it mutates and whether our early warning systems are in place. We are deploying huge amounts of resources to keep this administratively in check.

Q231 Lord Inglewood: When you say you have it in check, does that mean you think the extent of the fraud through the existing mechanisms employed by fraudsters is likely to decline?

Dawn Primarolo: Certainly the indications from the trade figures, ONS figures indicate there has been an absolutely massive drop. I cannot trip those off my tongue but we could send a note to the Committee demonstrating how effective and showing the amount of revenue that is now protected as opposed to vulnerable.

Q232 Lord Inglewood: We have had evidence given to us that the administrative measures you are taking are such that, for example, it is said that the approach frequently adopted by HMRC is that it is better that innocent people do not receive money they are entitled to than fraudsters get away with things. The effect of this is to be extremely damaging on the commercial viability of honest traders carrying out trade, which is, after all, very important for the national well being. What, if any, thoughts do you have about that?

Dawn Primarolo: I would rebut that suggestion. In all the Department is doing, and that will come out in subsequent questions and the difficulty in dealing with this issue, we are constantly reflecting that the vast majority of businesses, and the huge amounts of VAT flowing in and out of the Department, are discharging their obligations absolutely correctly and we want to do nothing to undermine those. We have an obligation to defend the revenue as well so we have to look at a balance. If we look at the numbers of registrations we are looking more closely at, you can still see that 95 per cent are going through on time or in under 25 days. There is a difficult balance to strike there between protecting the revenue and trying to deal with the organised crime and facilitating business and making sure they are not damaged. I am not complacent about it. I think we have the balance right but the Department constantly reviews it in terms of how many companies we might have that were investigated to a greater degree and turned out did not require it. That information is fed back into the system to help with the risk assessment. The figures do not indicate there is a wholesale assault, or even an unreasonable assumption, placed against legitimate business. In fact, if anything, we probably erred on the side of trying to protect legitimate business and still facilitate that and take more pressure than we should on the revenue.

Q233 Lord Inglewood: We have had evidence given to us, admittedly some of it hearsay, that there are individual businesses that are owed millions of pounds worth of VAT and that the delay is going to have the effect of putting them out of business. Of course you are right that you have to look after the interests of the taxpayer but, put it this way, it is rather bad luck if you happen to be one of the people who is put out of business.

Dawn Primarolo: We are not just randomly selecting businesses from the VAT returns. The Department has a risk assessment. The whole point is, on the face of it, it may be perfectly legitimate but the Department has a series of risk assessments that would then require, for instance, a registration to be looked at more closely. I agree there is a balance here between operation and facilitating business. If we look in the period April to December 2006, out of 284,000 requests for registration 3,543, to be precise, required closer scrutiny, a third of that number were rejected, 1,000 of the applications were registered but with conditions because we were still concerned, and the rest, so there is a proportion there, were registered but were in the longer time period. If you set that across all registrations, it is a small number and the challenge to the Department is to analyse how that small number which should not have been there got there and how we can refine the risk assessment to make sure we are not catching them subsequently. That is the best we can do.

Q234 Lord Inglewood: I agree that the challenge to the Department is to get it right. We have had some evidence from Hassan Khan & Co, solicitors, who are, I suspect, quite well known protagonists to the HMRC lawyers. Their letter concludes that the administrative approach, quite apart from any economic damage it might impose on the country, will almost certainly lead to problems in the courts. Their evidence concludes on that count: “It will also almost certainly in due course result in very significant damages claims against the United Kingdom for failure to adhere to basic accepted principles of Community law.” My concern is that in order for your administrative approach to work properly, you are going to find the only way you can do it is by consistent breaches of national and
European law and, therefore, you are between a rock and a hard place.

_Dawn Primarolo_: We are not breaching law. We might come on to the various ECJ cases—I will not do that now but we can come back to that—which quite clearly indicate the question of “knew”, “should have knowledge” or “could have had knowledge”. I refute what is being said. It is certainly true that this group of people who are seeking to steal tax money are very litigious and put us under considerable pressure. The test will be in the courts should there be a legal challenge. Mike possibly has some figures which would give you an indication of where we are with regard to verification. Can I make it absolutely clear that we are not breaching any European directives, rules or laws in any way. We are absolutely fairly and squarely right in the mainstream. We can come back to that.

_Mr Eland_: We are pursuing a policy which is really dictated by the recent European Court cases which say that repayments can be refused if the trader should have known about the fraud or did, in fact, know about the fraud. What we are doing with this verification campaign is to look at a whole range of suspect payments and investigate them against that test. There have been applications to the High Court for judicial review of this process to test precisely whether it is legitimate following those court rulings and whether it is proportionate and reasonable. Of the 14 applications for judicial review that have been heard, we have won in every single case. 11 of those 14 have been heard. It has been upheld in each of those cases that what we are doing is reasonable and proportionate and can continue. Three are still outstanding. This process has been subject to judicial scrutiny and has been upheld.

_Q235 Lord Inglewood_: If I could conclude by saying it seems what you are saying to us is it is your view that my basic proposition, which I put to you for your comments, that you cannot administratively deal with this problem other than by breaking the law, is not true and you feel you are, (a) dealing with the problem administratively and, (b) not breaking the law.

_Dawn Primarolo_: Precisely.

_Q236 Chairman_: May I just pick up on this. Were I to set up a business dealing in mobile phones and gain a VAT registration and then find myself trading, down the line, with a villain, is there guidance what HMRC’s considers a reasonable amount of due diligence to have done in order to ensure that you cannot be seen to be knowingly dealing with criminal persons?

_Dawn Primarolo_: Can I say that given how MTIC fraud is perpetrated, given the vast amounts of money, and given it is not connected actually with economic activity, it seems to me inconceivable that a trader could be in one of these supply chains and think that it was totally innocent. The court cases in the ECJ, _FTI_, _Bond House_ and _Kittel_, all return to a similar theme, and this was the question of knowing, or having reasonable grounds to know, that it was a fraudulent activity. Given that goods rarely move, in fact there are not any goods in many cases, HMRC would clearly supply advice, within the remit that they can, if a trader came to us and was concerned and indicated they were concerned and worried about their supply chain. I do stress when we talk about circular transactions 54 times through I do not know how many countries inside and outside the European Union, and sometimes in goods that are not even available on the market, it is a bit difficult to comprehend that they could not have known, although the Department’s job is to get the evidence according to the law to demonstrate that. I am a little surprised. In the industry where there is the greatest amount of attempted fraud, mobile phones and computer chips, they have remained silent because clearly all the legitimate businesses in that sector, which is the vast majority, have also something to gain by making sure that we squeeze this out of the system. If you suddenly decide you want to put in an application to refund £100 million in VAT and you have not actually done anything for it, chances are it is not a legitimate transaction.

_Chairman_: We do hope to talk to one of the biggest mobile phone companies to see if we can get a little closer to this.

_Q237 Lord Kerr of Kinlochard_: I want to make sure I understand your answer to the first set of questions asked a moment ago. The questions were about the scale of the problem. In your two memoranda of evidence you have given us numbers on the scale of the problem: in 2004–05, £1–1.19 billion; 2005–06, £2–3 billion, so a rising trend even though the numbers are broad brush. Am I right in thinking that in answer to Lord Inglewood’s first set of questions you said you thought the problem was now cracked? Can I assume therefore that the numbers for 2006–07, when complete in six weeks time, will show the trend reversed?

_Dawn Primarolo_: I was not saying it is cracked on the basis of qualification, and it depends where it mutates next if it does, but in terms of this particular carousel fraud with the mobile phones and the computer chips, the evidence we have at the moment, particularly through the ONS figures and our own operational evidence, is that there has been a huge downward pressure on that particular type of fraud and the potential losses to the Department and to the taxpayer are considerably reduced. Within the bounds of what I am able to release at this time, because we are not going to do a commentary on it,
it is at this point in time that I will ask my officials to provide a note to the Committee indicating where we believe we are. If we look at the ONS figures on trade and their estimates, which are done on a monthly basis, they show absolutely massive changes have taken place. The challenge will be what happens next and whether we can keep pace with it.

Lord Kerr of Kinlochard: A note would be extremely helpful.

Q238 Lord Inglewood: You rightly refer to a caveat: unless this mutates. Is there any evidence in the figures you have of a mutation actually taking place as of now?

Dawn Primarolo: As of now there is no evidence. The challenge is to make sure that the risk assessment ensures that should there be a change we immediately respond to it.

Q239 Lord Blackwell: I want to quickly follow up the point you made to the Lord Chairman about innocent parties and your point you thought it was inconceivable people did not know they were involved. One of the questions raised is not people who are found to be guilty but people whose VAT rebate may be delayed while investigation is going on and that delay could cause problems. Do you have any view or estimate of what the scale of numbers or money is involved in legitimate innocent traders who may have their VAT rebate delayed as a result of the administrative process?

Dawn Primarolo: I do not believe we have those figures because the numbers that we are talking about, in terms of the number of traders, is so small. Nonetheless, it is an important point if they should not have been in the process. That is the difficult balance that the department has to strike. Although there have been assertions and anecdotal evidence, we do not have any evidence at the present time that a legitimate company has gone out of business as a result of our verification. In all honesty, I could not put my hand on my heart and say it might not happen because that is always going to be a difficulty.

Q240 Lord Blackwell: On the information you have, you believe it is minimal?

Dawn Primarolo: That is what I currently understand, yes. That is information that has come to me. These are so highly complex and, because of the evidence we need, the investigation is so difficult that the Department is still erring on the side of saying we do not have any evidence at the present time that there have been assertions and anecdotal evidence, balance that the department has to strike. Although you believe it is minimal?

Lord Inglewood: You rightly refer to a caveat: unless this mutates. Is there any evidence in the figures you have of a mutation actually taking place as of now?

Dawn Primarolo: As of now there is no evidence. The challenge is to make sure that the risk assessment ensures that should there be a change we immediately respond to it.

Q241 Lord Steinberg: I was pleased to hear you say you believe you will massively change the figures, the current quotes of a loss of £2.75 billion to £3.5 billion in answer to Lord Kerr’s question. I would be very interested in seeing that figure coming down. Can I also mention OLAF? The number of investigations that OLAF do are considerable but the number of prosecutions resulting from their investigations are very few. I am hoping you are not tying yourself too closely to what investigations they are doing. Can I be a bit more specific? We are aware that some carousel traders have been using banks in the Netherlands Antilles, and the First Curacao International Bank is one of the ones we believe you are investigating. Can you tell me if you are investigating any other banks? Could you also tell me about the flow of money and the criminal activity and what way you are dealing with that? Can I then come on to the second part and say that the fraudsters currently seem to be using mobile phones as their area of “expertise”; are you prepared for a change in their tactics into other types of goods and maybe services? Would you expect the Department to be one step behind or up with events to counteract these particular frauds?

Dawn Primarolo: The first set of questions is around investigating. The Government and Department are investigating and discussing all possible opportunities and collaboration, within our legal constraints, to pursue a European-wide solution to this particular type of fraud. We are using at the moment our own administrative resources which are very resource intensive. It is a big challenge to the Department for all the reasons you have identified. It would be sensible to find those European solutions, and we might come back to that. The issue around evidence, around legal ability to share certain types of information, you will be aware, because Her Majesty’s Revenue and Customs Act went through the Lords as well, that we are under, rightly so, strict conditions on when we share taxpayer information, who the competent authorities are and, even with taxation treaties, exchange of information and under what conditions. Within those limits we are looking to see across Europe how can we co-operate and we are trying to force the pace. On the question of the First Curacao International Bank, I need to be very careful what I say here because the cases are live cases. This was a joint operation with the Dutch authorities. It is public knowledge that thousands of accounts in the First Curacao International Bank were frozen in connection with MTIC fraud and those cases are being pursued. I am not really able to divulge very much information on that. What I

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1 Note by Witness: The vast majority of all identified MTIC fraud has consistently been perpetrated using mobile phones and computer chips. There is no evidence of widespread mutation into other goods at this time, although a wide range of other goods have been and continue to be used. This is regularly reviewed by HMRC.
would say is the reason that I was in Dubai the weekend before last was because of the flows of revenue there and the co-operation that we are developing with the Dubai authorities. I do not think we have submitted a note to you on what has happened with the Dubai authorities and where we currently are in understanding and working with them but I think we can certainly provide that. That is the main focus. It is outside the European Community and we are following the flow of resources now from this Bank. You could ask further questions but I have been heavily advised I need to be very careful. I could reflect on this particular example and check with our lawyers whether there is anything more we might be able to tell you. With regard to the mutation and will we be one step behind or one step ahead, what I can say is that we have the risk assessments in place. We are in discussions with our European partners about where they believe the risks are and we have the ability now to respond far more quickly than we have before. One of the issues when you talked about figures in the Pre-Budget Report was partly there were two sets of figures that were published this time. One was in a continuum with the original way we calculated which gave us a much lower figure, but our extensive activity in pursuing this money has also given us more information which has enabled us to refine our understanding and we changed the calculation, hence the figure that you see now as the £2–3 billion impact on VAT receipts. I do not like to talk in terms of being one step ahead or one step behind. I would rather say we are doing everything we possibly can to have the assessments in place within the rules, within the realms of not impinging heavily on legitimate business. We believe we are in the best place we could be.

Q242 Lord Steinberg: Can you help a little more without divulging too much? I understand your difficulty. Can you tell me how many prosecutions are pending in relation to your own department? Can you tell me how many other banks you are investigating?

Dawn Primarolo: We are not investigating banks. We were in a joint operation with the Dutch, tracing revenue flows that then went somewhere else and resulted in the freezing of the accounts. We pursue the fraud itself through the chains. Once we are reasonably clear that it is a fraudulent chain with the evidence then we want to find out where the money is going. We are not investigating banks.

Q243 Lord Steinberg: Can I rephrase that slightly and say that the chain you follow of the fraud, does that lead certain banks to come up in relation to the fraud?

Q244 Lord Steinberg: I am not asking you to name them but the trail does lead you presumably to involve other banks.

Dawn Primarolo: The trail leads us to accounts that are in various places, yes.

Q245 Chairman: Can I take a supplementary while we are discussing enforcement prosecution. Do you work with the Serious Organised Crime Agency?

Dawn Primarolo: Yes, very closely.

Q246 Chairman: That is one of the things they are doing these days.

Dawn Primarolo: Indeed. They work in parallel with the supply of information, intelligence and helping us refine our risk assessment. Because it is about organised international crime gangs, obviously they are tracking and doing work in that area and information which assists us in pursuing stolen revenues. Quite a lot of the officers were part of the HMRC before and those very close relationships have been maintained, as you would expect them to be. They have expertise that we need to perform this.

Q247 Chairman: We have not heard an enormous amount about what SOCA are actually doing so I am glad to have traced a bit of it.

Dawn Primarolo: A very good job they are doing too.

Q248 Lord Cobbold: You are giving us very much the impression that you have a big problem more or less under control, you are beginning to win, but it still seems to be, standing back, you are still nibbling at the edge and the whole problem of this fraud and VAT system in Europe is easily moved to other countries and other products. Do you think this is a fair comment? Do you think there is a necessity to see a complete look at the VAT system and, if so, what would be the best solutions that could be achieved?

Dawn Primarolo: What I want to convey to the Committee is that our current administrative arrangements are a severe downward pressure on the potential loss. In that sense it is good we are not losing the volumes of revenue but they could still be a significant amount. There are questions raised rightly about how the VAT system works across the European Union. As I said at the beginning, this is not some clever re-interpretation with tax planning of the rules; it is outright theft. Yes, there are a number of things that need to be considered and some
Member States have put different proposals on the table. Austria and Germany want a full reverse charge. France is absolutely hostile to that proposition because it converts VAT to, in effect, a sales tax. If you can talk about the beauty of the VAT system, it is its fractional nature and so it is reducing the risk. If you can only collect the money at the last point, then you have some trouble. That is one area.

**Q249 Lord Cobbold:** You may reduce the risk but it is very open to fraud.

**Dawn Primarolo:** In our view, and what we are saying strongly to our German colleagues, it is actually in danger of increasing fraud because if you collect it at the last point these can be notoriously difficult points at which to extract all of the tax. That is one issue on the table. Other issues are greater control of cross-border trade which bring with it its own problems. Coming back to the point about how the system works to facilitate business, actually business likes the system we have now. The downside is we have this carousel fraud in it. It is a significant amount of money but a tiny number of perpetrators. The question of whether we would look at zero transfers again, whether the European Union needs to revisit whether or not we allow zero transfer between Member States, these are all possibles but they all bring with them other dreadful challenges and problems in terms of operation in a single market or actually how it would operate and the burdens on business. We prefer the combination of pressures actually how it would operate and the burdens on business. We prefer the combination of pressures.

**Q250 Lord Cobbold:** You do not agree with the German proposal either?

**Dawn Primarolo:** No, we are not sympathetic. We see the German proposal is that Member States could have a full reverse charge on an optional basis. Clearly not every Member State does that and that brings in challenges. It is a huge challenge to the tax administration in terms of how we go about collecting tax and at what point we collect it. The Germans also said they want the full reverse charge accompanied by very substantial regulations and controls on how the system operates. We take the view that would undermine legitimate business and is not the right way to proceed because there are other things we could do as Europeans to deal with this issue. They say you do not have to worry about mutation, but you have to worry about a highly complex system that is very difficult for business to cope with. We do not know what it will do in terms of a single market and it would hugely increase the compliance costs for tax administrations in trying to get the money and possibly lead to lower resources being collected because of the vulnerability of the end point.

**Q251 Lord Cobbold:** Is there a European impetus at all to move to the next stage which would be less open to fraud?

**Dawn Primarolo:** Yes, led by the Commission which we have encouraged. For instance, at the December ECOFIN the Commission were asked to accelerate their proposals, to bring proposals far more quickly back to ECOFIN for consideration for the more speedy exchange of relevant information. The summary of discussion, the conference later this month, will provide the basis on which to take forward the types of information and how Eurojust and Europol might have a role to play in helping to do that risk assessment and give us wider European analysis. The Germans and the Austrians have required that the Commission reports back by the end of this presidency on the implications for a full optional reverse charge in Member States. I have to say most Member States are not attracted to this proposition for the reasons that I have given.

**Q252 Chairman:** You are puzzling us slightly because we all thought that the Chancellor had welcomed French agreement for a derogation so that we could put a reverse charge on a couple of classes of goods, one being mobile phones. We are a little muddled to hear you say that you do not think it is particularly useful.

**Dawn Primarolo:** Sorry, I was talking about a full reverse charge. The Germans want to have a full reverse charge across the whole of the system in a Member State on an optional basis. There is precedence for this, a small precedence, for instance when there were difficulties with gold bullion and a reverse charge was used. We believe that a limited reverse charge helps us target it, because it still has downsides in that very limited area. The targeted reverse charge plus administration, plus looking at some of the administrative rules offer the way forward.

**Q253 Lord Cobbold:** Would you not be following the fraudsters and their next step?

**Dawn Primarolo:** That is the issue. The reverse charge by itself is not a complete solution we need further consideration by the European Member States on how we could improve our current exchanges of information and collaboration in order to be sharing information much more rapidly which would enable Member States to act promptly where there was a
potential risk to their revenue. That is the only way forward if we are not to have a completely new system which business would not like. It is the balance that we talked about earlier on.

**Q254 Lord Cobbold:** Is there any evidence of services being used by the fraudsters in Austria?

**Dawn Primarolo:** No, we have no evidence of that. We have seen nothing in our systems that indicate that. The difference is we are tracking them. Other Member States may suggest that it is going into other products but we have no evidence of that.

**Q255 Lord Inglewood:** I wanted to ask a question quite similar to yours. As I understand it, you said to me and to Lord Kerr we were on top of the problem as currently constituted. That being so, I cannot see why the Chancellor went and requested the reverse charge in this area. If we are on top of the job, then there is no requirement for it is there?

**Dawn Primarolo:** It is a question of resources. I have said repeatedly we are deploying huge amounts of resources to try and hold this in check. The reverse charge would hold it in check. We could then monitor and use our resources to chase up other things.

**Q256 Lord Inglewood:** You could then release resources to chase up something different.

**Dawn Primarolo:** Indeed.

**Q257 Lord Kerr of Kinlochard:** Are you going to obtain a derogation?

**Dawn Primarolo:** I am hopeful that we will, yes. It is not unusual for requests for derogation to take this sort of time. There is the issue of some of the technical detail because of the concern for the wider reverse charge which is across the whole of the VAT system in a Member State. The French in particular, and we still have some technical details to settle, are concerned that our reverse charge will be a stalking horse for something wider. That is not the case. We need to settle these outstanding points which I hope will be done.

**Q258 Lord Jordan:** We have looked at most of the reforms that have been mentioned here today. Whenever we mention them to witnesses we either get visions of further problems, if they are implemented, or resolute objections from other Member States. What has come across is that several witnesses said that one of the major flaws in the system was allowing goods to be traded across EU borders without VAT. One, do you agree with this and, two, do you have or know of any specific amendment which is likely to be proposed in the current VAT rules at EU level that would actually make it less susceptible to fraud?

**Dawn Primarolo:** Removing the zero rate for cross-border supplies of goods is certainly one possible way of dealing with MTIC fraud. However, and it is a very big however, it brings with it its own enormous difficulties in that how we manage, across all the Member States, the collection and paying of VAT on its current basis. If we had a piece of paper which on one side said what is pro for business having a zero rate and what is minus, it is an enormous difference. Given it facilitates trade and is of such enormous importance across the single market and operates for the overwhelming majority of legitimate business as well, the obligation on us is not to take away something that is of such great benefit to business and the consumer. The obligation on us is to find out how, by co-operating together, we can deal with these rogue traders, these organised criminal gangs and that is the path we are taking.

**Q259 Lord Jordan:** You have referred to organised crime and it has been obvious to us that the colossal rewards which carousel fraud can deliver has surely attracted organised crime across Europe. Is the UK being targeted by them because of its perceived VAT registration regime and, if it is, what are you doing to deter them? Is there evidence that we are moving in the direction of more severe sentences? We have heard about the odd one now and then. The detection rate, which is another great deterrent, is that going in the right direction? Are there more victories than reported crimes?

**Dawn Primarolo:** We have no evidence which suggests that somehow organised crime is attracted to the UK. The prosecutions we are seeing through our own courts, increased sentences, severity with which the judges are taking prosecutions in this crime, there is no evidence there is a migration to the UK. Certainly some of the principals who have been prosecuted so far are UK nationals, UK-based. Clearly they do work internationally and that is why we need international co-operation because the chain goes outside our jurisdiction and we have to prove across the chain. The combination of prosecutions in the court, the firmness of the requirements on evidence following clarification of the three ECJ cases—because the Bond House ruling in the ECJ took away one of the legal points that we relied on in prosecution, although then the subsequent Kittel case did bring in and reinforce the knowledge or “should have known” point—indicate we are in the right place but we should not underestimate. These people are incredibly well resourced. They have the very best legal minds, accountants and everybody else, and so have we. They are not opportunists; they plan this as their business and we are trying to tackle it in a much more
Q260 Lord Jordan: It is still easier than robbing banks.
Dawn Primarolo: If you like it is a mutation from robbing banks. Robbing a revenue pot is what robbing a bank was. We are talking here about the tax authorities but I would hazard a guess if you were able to speak to the banks about theft and identify fraud and their losses you would find that international crime of this type is not just something that governments are victims of; it is international and it does require that international co-operation, and co-operation between all of the legitimate players not just governments but banks, advisers, et cetera.

Q261 Lord Kerr of Kinlochard: I would like to follow up briefly on what the Minister was telling us about her views on alternative systems. You were very clear on the arguments against an origin system of the kind the Commission first proposed, in particular the costs, and the technical and practical challenges, of a clearing house system. You also were against the variant that the Germans proposed, and I agree with you: additional optionality does not make it any more attractive. But when we took evidence from Commissioner Kovacs in Brussels he mentioned another possible future prospect. He did not think this was the most urgent task, and agreed that the most urgent task was to improve information exchange systems. But he also talked about the possibility of moving to a new variant of the origin system, whereby the tax levied at the frontier on the intra-European export would be the tax chargeable in the country of destination. This would, as far as I can understand, eliminate the need for a clearing house. He was not suggesting that this was a question for today. His priorities sounded very much like yours. But I thought his was an intriguing suggestion for tomorrow. What do you think about it?
Dawn Primarolo: It may well be an intriguing question for tomorrow but it would leave the UK pursuing the collection of billions of pounds of revenue from companies outside the UK net who we might not have a relationship with in terms of them not being registered with us. The challenge would be what would be the administrative structure we would need under those circumstances, which we do not currently have in order to collect those not insubstantial amounts of revenue. We are talking of tens of billions.

Q262 Lord Kerr of Kinlochard: Would you not be receiving the tax from a fiscal authority that had collected it, rather than from the initial manufacturer?

Dawn Primarolo: The discussions have been varied on that. Then there is the question of revenue sharing.

Q263 Lord Kerr of Kinlochard: I do not think that was part of Commissioner Kovacs’ proposal. It seemed to be simply there should be VAT on intra-EU exports, but collected by the tax authorities of the exporting country at the rate payable in the destination country, which seemed to be a rather elegant solution.
Dawn Primarolo: The specific issue is how a Member State would be assured that it was receiving the revenue that it was entitled to, and then systems have to be put in place. I agree, on the simple proposition that the Commissioner puts, it appears superficially attractive. The challenge then comes how to make it operate across all Member States, particularly when we look at the revenues of some of the Member States that we are actually talking about. How much goes through our VAT system in a year?
Mr Brown: £40 billion. If you were talking about allowing this sort of system Commissioner Kovacs just mentioned, for the UK there would be £20 billion of tax expected to be collected via other authorities. In order to trust them with that we would have to be very confident about the rates of compliance, and so on, that are associated with the payments. If the compliance rate was only 90 per cent, which actually is a high figure, you are still talking about revenue losses to the UK which are comparable to the MTIC losses that we have been talking about today.

Q264 Lord Kerr of Kinlochard: You would be, if these numbers were correct. But it seems to me that the chances of establishing a relationship of trust with your counterparts in the other Member States are rather higher than the chances of establishing a total trust with all the traders. I would have thought this is not impossible as a proposition.
Mr Brown: As Commission Kovacs said, it is not an idea for today, one would be looking at tomorrow.

Q265 Lord Cobbold: Would the fraudsters not be able to source exports and imports of products outside the EU because there would be no VAT on those? It would still be possible to create a fraud.
Dawn Primarolo: It is difficult to speculate because of the fraudster’s attempt in any system to find ways to defraud, whether it is the tax authority or someone else. Any system is going to have the potential. What we are trying to balance is minimising loss to the revenue with minimum implications and inconvenience for the vast majority of businesses who find the system, as it is currently constructed, very beneficial.Obviously my position as a Minister is that I am keen to find a way to stem the loss of revenue within the rules. We are doing all we can to achieve that but, in the end, whatever system we have those
are the principles that we will be balancing. I am keen that whilst propositions for the future, which may be complicated, should be there, there are a number of steps that can be taken now that we should get agreement on that would make it—I was going to say easier but that is not a word we should use—put us in a better position to challenge this fraud than we currently are.

Q266 Lord Inglewood: Can you specify what those might be in general terms?

Dawn Primarolo: We need to speed up information exchange, and the Commission has already been asked to bring forward proposals. We need to look closely at what would be the role of Eurojust and Europol. How do we facilitate particularly evidence exchange? We need to try and get to a position where we understand a base line across Europe so then we can measure progress of whether we are actually dealing with this. We need to further explore the combinations of domestic administrative changes by Member States and whether targeted very narrow reverse charges can actually squeeze it out of particular types of goods. It seems to me that is the policy mix that we need to advance at the present stage, not leaving out the discussions for tomorrow but deal with today at the same time.

Q267 Chairman: If I might try to wind up. We are very grateful to you and your colleagues for coming to talk to us. You have surprised us about being more optimistic than previous evidence suggests about the progress you are making in dealing with this particular fraud and it is encouraging to us. At one point it did all sound very doom and gloom. We would be very glad of anything you can let us have by way of a note as to how you are getting on with prosecutions and dealing with fraud. We perfectly understand there are areas which you cannot tell us about. In view of this, do you think you are going to get enough co-operation out of Member States? What is the level of political will to agree on an anti-fraud strategy and to co-operate with each other to tackle that fraud? Are some better than others? The impression from outside, when you see people arguing about each other’s methods of tackling fraud and many countries not willing to let us have the derogation we would hope to have to reverse charge on specific goods, one begins to wonder how much co-operation there is.

Dawn Primarolo: The political will is there to tackle it and the co-operation is there. The issue at the moment is there are slightly differing views on how it should be tackled, and that needs to be settled as quickly as possible. Within that we are trying to advance an agenda that would improve regardless of whether those wider questions of differing approaches are settled. It is a very complex, difficult issue that goes to the heart of the VAT system, its fractional nature and its zero transfer in the market, and that makes it particularly challenging at this time. To ensure we do supply you with the information, perhaps you may decide there is a little more you want, if you could send us a note of the specific points then we will respond as quickly as we can.

Q268 Chairman: Another specific point occurs to me. Have we an estimate of how much enforcement is costing us because that would be a useful piece of data.

Dawn Primarolo: How about a lot.

Q269 Chairman: How many people are engaged would do just as well.

Dawn Primarolo: We can give the staff numbers. We can do that definitely.

Supplementary letter by Rt Hon Dawn Primarolo MP, Paymaster General, HM Treasury

INQUIRY INTO MISSING TRADER FRAUD

Thank you for your letter of 7 February, requesting some further evidence following my appearance before the Committee on 6 February. I offered to provide the following information:

— Data demonstrating the effectiveness of HMRC’s strengthened operational strategy for tackling Missing Trader Infra-Community (MTIC) VAT fraud;
— The staff numbers currently deployed on that strategy; and
— Details of our work with the authorities in the United Arab Emirates/Dubai.

You also asked for information about HMRC’s MTIC fraud estimates, which are published each year alongside the Pre-Budget Report; and about any consultation with businesses on the proposed reforms to the EU VAT system to counter cross-border fraud. In addition, I have provided some further information on the UK’s involvement with the Eurocanet project, and the Government’s response to two questions that were not covered on the day:
6 February 2007

— Improvements to the IT infrastructure used to exchange information with our European partners;
and
— The use of a “trusted third party” along the lines of the Streamlined Sales Tax model used in the USA.

All of the above information is annexed to this letter. I hope that it will assist the Committee in preparing its report on Missing Trader fraud.

Finally, as I mentioned when we spoke after the hearing, if the Committee would find it helpful, HMRC would be able to provide a confidential oral briefing on the criminal investigation activity relating to the First Curacao International Bank, and subsequent money flows. This would need to be done in a closed session, and with the clear understanding that the material divulged could not be used in any subsequent publication. If you or other members of the Committee wish to receive such briefing, may I suggest that your Clerk contacts Roy Clark, the Director, Criminal Investigation in HMRC.

27 February 2007

Annex A

THE EFFECTIVENESS OF THE UK’S STRATEGY FOR TACKLING MTIC FRAUD

In February 2005 the Advocate General released his Opinion on an ECJ case concerning a legal argument used in the UK to deny suspect VAT repayment claims from those operating in MTIC carousels. The Opinion created legal uncertainty in the application of this anti-fraud measure until, in January 2006, the ECJ ruled that EU law did not allow the approach taken by the UK, but provided an alternative basis on which to refuse suspect and abusive claims.

This sequence of events prompted a significant rise in the trading activity associated with MTIC fraud during the second half of 2005–06 and the first quarter of 2006–07, for which there appears to be no commercial or economic rationale. In response, HMRC strengthened their operational strategy and increased resources in order to verify a greater number of VAT repayment claims that bear the distinct indicators of involvement with MTIC fraud. A subsequent ruling by the ECJ in July last year has clarified the legal test to be used when refusing suspect and abusive claims.

The Office for National Statistics, using overseas trade data supplied by HMRC, publishes monthly estimates of the value of UK trade that is missing or under-reported as a result of MTIC carousel fraud. That data, contained in the table below, provides an indicator of the level of MTIC-related trading activity, and demonstrates how the cases mentioned above and HMRC’s operational strategy have impacted on the fraud.

<table>
<thead>
<tr>
<th>Quarter ending</th>
<th>Value of MTIC-related trade (£bn)</th>
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<tbody>
<tr>
<td>September 2004</td>
<td>0.6</td>
</tr>
<tr>
<td>December 2004</td>
<td>0.7</td>
</tr>
<tr>
<td>March 2005</td>
<td>1.0</td>
</tr>
<tr>
<td>June 2005</td>
<td>2.3</td>
</tr>
<tr>
<td>September 2005</td>
<td>3.5</td>
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<tr>
<td>December 2005</td>
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<td>14.3</td>
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<tr>
<td>September 2006</td>
<td>2.2</td>
</tr>
<tr>
<td>December 2006</td>
<td>0.6</td>
</tr>
</tbody>
</table>

1 Bond House et al, joined cases C-354/03, C-355/03 and C-484/03.
2 Axe/Kittel and Recolta Recycling, joined cases C-439/04 and C-440104.
3 Note that export trading typically results in a VAT repayment claim being submitted to HMRC between one and four months later.
RESOURCES USED IN HMRC’S OPERATIONAL STRATEGY TO TACKLE MTIC FRAUD

As HMRC strengthened their strategy to tackle MTIC fraud, they re-deployed an additional 700 compliance officers to verify suspect VAT repayment claims. This brought the total number of HMRC staff currently used on the strategy to over 1,500.

Recently, HMRC have decided to further increase their criminal investigation capability, and 68 extra staff will be redeployed to MTIC work in the year 2007–08.

WORKING WITH THE AUTHORITIES IN THE UNITED ARAB EMIRATES (UAE)

HMRC (and the former HMCE) have a long history of law enforcement cooperation with overseas authorities, and UK Law Enforcement Liaison Officers have been based in the UAE for around 15 years.

Throughout this time there has been good cooperation and a number of significant operational successes. More recently the UK has also supported the UAE in capacity building projects, working in particular with the UAE Federal Customs Authority and in Dubai with Police and Customs. HMRC signed a cooperative Memorandum Of Understanding (MOU) with Dubai Customs in 2005, allowing the exchange of information about imports and exports between Dubai and the UK. An MOU with UAE Federal Customs will be concluded later this year.

HMRC has also supported the FCO in concluding a Mutual Legal Assistance Treaty (MLAT) with the UAE last December. This allows the exchange of information and evidence in support of criminal investigations to tackle various forms of fraud including MTIC fraud.

Using these new agreements and the strong relationships that now exist between HMRC and several agencies and authorities in the UAE (the Dubai police, the Attorney General’s office in Dubai and the UAE Central Bank Authority), action has been taken against persons suspected of laundering the proceeds of MTIC thefts through UAE bank accounts.

As I explained at the hearing, I recently visited to thank the UAE and Dubai authorities for this assistance, and received strong statements of their continuing support.

HMRC ESTIMATES OF MTIC FRAUD

As I explained to the Committee, in the financial year 1995–96, VAT receipts came in significantly below forecast, and work began to investigate the reasons behind this shortfall. The UK subsequently developed a strategic approach to tackling indirect tax losses, including those arising from MTIC fraud. The MTIC fraud strategy was launched in September 2000, and HMRC has since published annual estimates of MTIC fraud levels alongside the Pre-Budget Report. The earliest such data covers the financial year 2000–01.

The estimates published alongside last year’s Pre-Budget Report were as follows:

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>Lower estimate (£bn)</th>
<th>Upper estimate (£bn)</th>
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</thead>
<tbody>
<tr>
<td>2000–01</td>
<td>1.3</td>
<td>2.5</td>
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<td>2001–02</td>
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<td>2002–03</td>
<td>1.5</td>
<td>2.3</td>
</tr>
<tr>
<td>2003–04</td>
<td>1.1</td>
<td>1.7</td>
</tr>
<tr>
<td>2004–05</td>
<td>1.1</td>
<td>1.9</td>
</tr>
</tbody>
</table>

The methodology used to produce these estimates relied on measuring a gap identified through official returns. However, as fraudsters have changed the way they operate, this methodology no longer provides a reliable estimate of MTIC fraud. The estimated range for MTIC fraud in 2005–06, using this methodology, was...
between £1.4 billion and £2.4 billion, but this estimation was not supported by operational indicators. As a result, this measure has been discontinued.

Instead, for 2005–06 HMRC produced an assessment of MTIC fraud based on operational evidence and this was also published alongside the Pre-Budget Report. The estimated scale of attempted fraud during 2005–06 is between £3.5 billion and £4.75 billion. HMRC also estimated that in 2005–06 VAT receipts could have been reduced by between £2 billion and £3 billion, reflecting the fact that HMRC’s operational strategy was able to stop a significant proportion of the attempted frauds.

Annex E

CONSULTATION WITH BUSINESS ABOUT PROPOSED REFORMS TO THE EU VAT SYSTEM

HMRC have consulted with businesses on action to combat VAT fraud. Businesses generally have commented that action should be targeted at the fraudsters and should not impose burdens on legitimate businesses. Some have stated that the current arrangements for intra-community movements of goods, which are effectively VAT-free, represents a facilitation to trade engaged in cross border supplies and should be retained. Overall most businesses that commented did not see the need for a fundamental change to the VAT system that worked perfectly well for the vast majority of companies engaged in cross border trade.

Many businesses were aware of suggestions by some Member States for a wide reverse charge that would affect all goods and services above a certain threshold. Most that commented were deeply concerned at the comprehensive reporting requirements that accompanied the system and the additional costs involved. For similar reasons the Government has not seen any significant support for the type of “modified origin system” proposed by the Commission although some businesses have historically supported an origin system where governments undertake all the necessary redistribution and refunds of tax associated with the regime.

Annex F

IMPROVEMENTS TO THE IT INFRASTRUCTURE FOR EXCHANGING INFORMATION WITH EUROPEAN PARTNERS

The Committee asked:

Have you had any success in your aim, stated in your evidence, to bring forward the timetable for improvements to the IT infrastructure used to exchange information ahead of the Commission’s planned timetable of 2009–11?

and, related to this point, you indicated that the Committee was interested in any investment in HMRC’s internal IT systems for information exchange, and monitoring trades in “real time”.

The UK has played an active role in taking forward work to improve the IT infrastructure used to exchange information between Member States. We were pleased therefore that the ECOFIN Council agreed in November on the need for a more rapid exchange of VAT information. I can confirm that the Council has invited the Commission to prepare a strategy and to publish an action plan for taking forward this important work, and we are currently awaiting proposals from the Commission on how they intend to take forward discussions on this issue. In parallel, a small project group, involving the Commission and Member States, has been established to look at practical ways of improving the overall functioning and efficiency of the VAT information exchange system. The UK is playing an active role in that group.

It is true to say that some interest has been shown in real time reporting systems on a transaction by transaction basis, indeed this has been put forward as a feature of a wide reverse charge. Understandably businesses are concerned at the administrative cost of such an approach, which could be in the region of £1.3 billion. However, the problem is not with the basic system (which records details of VAT registered taxpayers, together with their intra-EC supplies and acquisitions) but rather with the speed with which the VAT data is collated and exchanged.

We believe that this can be significantly improved without imposing undue burdens on business, in such a way as to be a valuable tool to tax administrations in the fight against VAT MTIC fraud. In the interim HMRC is actively reviewing how it can further improve the efficiency and effectiveness of its IT systems and the quality of the information held in its databases. For example HMRC is actively promoting electronic direct trader input of data and considering the extent to which that data can be automatically validated at the time of entry.
6 February 2007

Annex G

INVOlVEMENT OF A TRUSTED THIRD PARTY

The Committee asked:

Would the involvement of a trusted third party, as we understand is integral to the Streamlined Sales Tax in the USA, assist in reducing MTIC fraud whilst at the same time reducing the risk for the innocent trader that his input tax claim will be denied?

The Streamlined Sales Tax Project, which began in March 2000, was created by the federal states in the US, with input from local governments and the private sector, to simplify and modernise sales tax collection and administration across the states, where differing rates and legislation created a large burden on business. The role of the Trusted Third Party included:

— Receiving required information on transactions from a seller and providing software for determining the taxability of a transaction, the appropriate state and local tax rate, and the tax due.
— Providing tax information to sellers at the time of the sale, so that information on tax due is available to a customer before completion of the transaction.
— Entering into arrangements with credit card and other electronic payment processors so that tax(es) owed to the state or local government could be remitted directly to the TTP for transmittal to the state.
— Providing all transaction and return information to the states (and local governments where appropriate) along with the tax remittance.

The UK has participated in OECD discussions on the role of trusted third parties in tax collection mechanisms. At the time, consultations with business revealed concerns regarding both costs and sensitivities with commercial data. The Government understands that the same issues have arisen in the Streamlined Sales Tax Project where the role of trusted third parties is not a major aspect of the overall changes.

We are open to new ideas for combating MTIC fraud and are continuing to evaluate the role of trusted third parties, although we do not see this as a solution in the short term due to the complexities involved. We also wonder whether any third party would be willing to take on the commercial risk associated with the collection and payment of the tax, given the scale of the organised criminal attack on the VAT system that we have seen in recent years.

Annex H

UK INVOLVEMENT IN THE EUROCANET PROJECT

The Eurocanet project (the European Carousel Network) came into effect on 1 January 2005 and is administered by the Belgian VAT Carousel Fraud Unit (OCS). There were initially five Member States involved, including the UK. Currently all Member States, with the exception of Germany, participate, to a greater or lesser extent, in the project. The project involves the monthly exchange of European sales list data and clearance requests of VAT registration numbers between participating Member States in respect of certain targeted traders. Its main objective is the early identification of missing or potentially defaulting traders. Each Member State can request another Member State to closely monitor a trader. A maximum of five suppliers can be monitored in a Member State.

In November 2005, OLAF proposed that it should become an external partner of Eurocanet and sought access to the data held. The UK and some other Member States do not recognise the competent authority of the EU Commission, and therefore OLAF, to exchange taxpayer confidential information under EU Regulation 1798/2003, which provides for administrative cooperation in the field of VAT between Member States. Furthermore, in the UK Government’s opinion, giving the Commission the same powers as Member States to request investigations in order to provide information could cause delays and would have resource implications.

The UK sought reassurance from OCS that any data supplied would not be shared with OLAF and, in the absence of such assurances, has not provided any data since December 2005. Eurocanet is of benefit to those Member States whose anti-fraud systems lack sophistication. The UK already has systems in place that can
identify missing and defaulting traders far more quickly than through the Eurocanet process, e.g. through pre-registration checks and, where a missing trader escapes those checks, by analysing domestic supply chains and tracing suspect deals elsewhere in the chains back to the tax loss caused by the missing trader.

Further supplementary letter from Rt Hon Dawn Primarolo MP, Paymaster General, HM Treasury

Thank you for your letter of 9 March with some further questions on Missing Trader Intra-Community (MTIC) fraud.

Mutation into Other Sectors

The Committee has asked whether the fraud has moved into other sectors. As you know, mobile telephones and computer chips have long been the fraudsters' commodities of choice. However, they have always used, and continue to use, a wide variety of other goods, ranging from textiles to razor blades and golfing equipment. HMRC has also seen evidence of some traders, historically linked with trading in mobile phones, diversifying into goods as disparate as pharmaceuticals and soft drinks, despite still advertising their business activity as being linked to telecommunications and electronic goods. However, the goods most commonly used in the fraud after mobile telephones and computer chips are other low-volume, high-value electronic goods, such as iPods and Satellite Navigation systems, and we have taken action against this mutation in the Budget.

EU Fraud Summit

The Committee also asked which law enforcement and tax authorities were represented at the EU summit hosted by HMRC on 21 February. All Member States except Bulgaria, Cyprus, Finland and Luxembourg were represented, and most countries sent one delegate from the tax administration and one from the main law enforcement agency, often the police. In addition, representatives from Eurojust, Europol, the EU Commission, OLAF, and Switzerland attended the summit. The UK delegates were from HMRC and HMT, the Scottish Crown Office, SOCA, RCPO and the Foreign Office.

Cost of the MTIC Strategy

The Committee has asked about the cost of the staff that HMRC is currently using to tackle MTIC fraud. As I have previously advised, in response to the unprecedented increase in attempted fraud over the past year, HMRC has re-deployed around 700 extra staff to the MTIC strategy, bringing the number of enforcement and compliance staff used on this work to over 1,500. This figure does not include those staff who support the MTIC strategy, such as prosecutors and financial liaison officers in embassies around the world, or staff whose primary role is administrative, such as VAT registration staff, those processing VAT returns and payments, and debt management teams.

The full year costs for 2006–07 for 1,500 staff are around £95 million. This includes paybill and general overhead costs.

The 1,500 enforcement and compliance staff are solely involved in protecting the tax base from attempted theft by MTIC fraudsters. HMRC has estimated the scale of that attack in 2005–06 as between £3.5 billion and £4.75 billion. This compares to around 4,400 staff employed in assuring the remainder of the £127 billion of VAT collected and £54 billion of VAT paid out by HMRC each year.

Prior to the very rapid increase in attempted fraud last year, the previous MTIC staffing levels had been sufficient to keep the fraud under control. In responding to that increase, HMRC has had to balance the need to act quickly to counter such an attack, identifying, training and deploying staff with the right skills and aptitude for this challenging work, whilst at the same time, maintaining sufficient resources on enabling and assuring other compliance activity within the wider tax system.

Verification of Suspect VAT Repayment Claims

The Committee has asked how many traders are currently subject to HMRC’s verification strategy, in response to an allegation that HMRC is applying a blanket approach to particular sectors. I do not want to make public details of HMRC’s operational activity, but I can give some assurance that HMRC’s strategy is risk-based and is not focused on particular sectors. Last year the level of VAT repayment claims from those suspected of trading in supply chains associated with MTIC fraud rose very rapidly, defying any economic or
commercial logic. As a result, HMRC is now verifying a greater proportion of VAT repayment claims from such traders, regardless of which sector or goods they trade in. These traders represent a tiny fraction of the 1.9 million VAT registered businesses in the UK and, to date, the Courts have been generally supportive of HMRC’s policy and practice.

**Reverse Charge**

Finally, the Committee asked for an update on European negotiations on a “reverse charge” accounting system for the goods most commonly used in MTIC fraud. As I have already advised you separately, political agreement to the necessary derogation was secured on 19 March, and the Government has announced that the reverse charge will be introduced in the UK on 1 June 2007.

The Chancellor also announced in his Budget two further measures to tackle the fraud. With effect from 1 May 2007, the provisions that allow HMRC to make one trader jointly and severally liable for another’s (fraudulent) tax debt will be extended, to cover other electronic goods as well as telephones and computer parts; and the Finance Bill will include a clause allowing further changes to these provisions to be made by Treasury Order. These measures will ensure that HMRC’s operational strategy is able to respond swiftly and flexibly to future mutations in MTIC fraud.

I hope that the Committee will find this further information helpful.

*27 March 2007*
TUESDAY 27 FEBRUARY 2007

Memorandum by Royston Ford, Cunningham Lindsey Marine

1. I wish to respond to the public call for evidence on this subject. I am a surveyor and investigator specialising in claims, losses and “incidents” occurring in the context of the movement of goods in international trade and logistics. Investigations include incidents of damage, theft and fraud.

2. I have been employed in this capacity since 1993 having previously served as a Lloyds of London broker (Marine and Cargo business). Over the last four years I have been retained on a frequent basis by insurers who underwrite the specialist, and high-risk, movement of “technology” traders’ goods. This includes CPU’s and computer systems/components, mobile telephones and related accessories or equipment.

3. I am writing in a personal capacity as a professional interested closely in this subject. I am not writing for or on behalf of my employer or its clients and my evidence does not necessarily represent the views of those parties.

4. I am not qualified to discuss the effects that MTIC fraud has on the legitimate trade in related goods but do wish to offer a view of the effect that the fraud has had on the insurance industry and perhaps to some extent on legitimate traders because of the way in which the fraud has driven other crimes.

5. I also wish to highlight some ways in which MTIC traders are evolving the fraud and defeating many of the preventative measure adopted by Revenue and Law Enforcement agencies.

6. Losses in these sector forced most UK composite (and specialist insurers) to refuse to cover traders in these sectors and since 2003 this business has been almost exclusively underwritten by an insurer in Switzerland who have retained my firm’s services on an exclusive basis.

7. As a result I have been involved in the investigation of numerous occurrences of theft, robbery and fraud arising from the trading of mobile telephones and computer equipment (estimated total value ca. GBP40 million) and have worked with police (operational and intelligence units) and HMRC on a frequent basis. These investigations have involved enquiries in the UK, mainland Europe and Dubai (which features as a principal “node” of MTIC fraud networks).

8. As a result of these investigations it has become clear to me that the majority of the trade in mobile telephones and computer processors is entirely vitiated by MTIC VAT fraud.

9. It is also apparent that the VAT fraud is both an instigator and a multiplier of other crimes—particularly theft of cargo in transit (most often by violent hijacking of the carrying vehicles) and robbery (frequently armed) from warehouses. It also leads to fraudulent claims against insurance covers and may well also lead to the operation of insurance facilities with the object of laundering the financial proceeds of the VAT fraud.

10. One aspect of the MTIC fraud in mobile telephones is that the parties to the fraud must ensure that they do not have in their possession any database or other record of the IMEI numbers of the telephones they are trading in a circular pattern. The reason is obvious: That such records (showing repetitive transaction of the same goods) would indicate (to HMRC) knowledge on the part of the trader that he was involved in a fraudulent trade.

11. The effect of this is that the MTIC cargo travels with no record being kept of the IMEI (or serial or other identifying references). This fact is not lost on other criminals who are aware that if they can steal the MTIC telephones then the owner will be unable to provide, to law enforcement agencies, information which would identify the stolen goods. The robber or hijacker of the phones need only prepare a relatively weak “legend” for the cargo which suggests it was purchased legitimately and law-enforcement, should they have grounds to suspect goods to be stolen, will be wholly unable to prove it.

12. There are manifold examples of criminals obtaining information on the movement of MTIC consignments from “inside sources” at the relatively small number of freight forwarders and carriers specialising in this high-risk trade. Intelligence and monitoring of known outlets for stolen goods suggests that these hijacked or stolen cargoes are not offered for onward sale. This suggests that the thieves are not always motivated by immediate financial profit following sale of the loot but rather that the consignments are possibly
stolen to order, as stock for MTIC activities or that the consignments are in fact targeted for theft by the MTIC trader/owner of the property.

13. The reasons for an MTIC conspirator to target its own consignments are predominantly one or both of two options. The first is that the consignment is no longer useful to the MTIC conspirators. Either it has travelled the carousel for so long that it is now obsolete (phones are rapidly superceded by newer and better models) and has a much reduced market value because the boxes and packaging are damaged and worn and over the lifetime of circular trading the cartons have fallen victim to repeated pilferage (by warehouse personnel and drivers all too aware that the cartons are not going to be opened and the phones released for sale to consumers.) The secondary reason is that the MTIC trader becomes aware that a consignment has been intercepted by HMRC officers and the IMEI numbers scanned. The consignment is now “too hot to handle” and must be disposed of. If it can be disposed of in a manner that leads to a recovery from an insurer then so much the better. Hence the staged hijacking or robbery—phenomena which police statistics will clearly demonstrate to be linked statistically with the rise and fall of MTIC fraud activity.

14. It is common for freight forwarders specialising in this trading sector to operate “Open Cover” insurance facilities. These are policies provided by an insurer to the forwarder so that the forwarder is authorised to accept, on behalf of the underwriter, cargo insurance risks proposed by the forwarder’s clients. The trader instructs the forwarder to ship a consignment from A to B and also to insure it for the duration of the voyage. The forwarder charges a premium to the client and on monthly declarations it advises the underwriter of the insurances effected and pays over the premium charged, less a commission retained by the forwarder.

15. Since FSA regulation which would have required the forwarders to become FSA registered and compliant with the regulation of such insurances, the forwarders established offices in Dubai from where they continued to operate these “open covers” free from UK regulation. Customers of “Bloggs Freight Limited” knew that they could apply to “Bloggs Freight LLC” in Dubai for their insurance cover. More often, the insurance was, de facto, sold and effected in the UK in clear technical breach of the FSA regulations.

16. There are numerous examples of fraud in the operation of these open covers in Dubai whereby forwarders accepted risk and premiums but failed to declare them and pay premiums over to the insurer unless a loss occurred in which event the victim’s insurance was of course properly placed with the underwriter after the fact.

17. Because of the decidedly murky operation of these insurance instruments, there is a very real fear that these unregulated activities may be used for the purposes of money laundering. In at least one case where wholesale fraud was detected, the forwarder concerned operated an “Insurance Division” in Dubai and issued cover certificates in its own name. Premiums were handled through a bank account with the First Curacao International Bank in the Netherlands Antilles. This bank, used by MTIC traders, has now been liquidated and its beneficial owner is currently remanded in custody in the Netherlands on charges of running a criminal enterprise, handling stolen property and money laundering—all in connection with the MTIC activities of its account-holding customers.

18. The concern is that a fraudulently operated, unregulated insurance vehicle is the ideal conduit for money laundering particularly when operated by a freight forwarding or transport company. Such a company, if it were so minded, would have at its disposal all the experience and documentation necessary to create a high-value cargo which existed only on paper and to engineer grounds for an insurance claim in respect of the cargo which it could settle in order to have “clean” funds paid over to the cargo-owning “claimant”.

19. The extent of corruption within the trade in these MTIC commodities, and within the freight companies which service the “industry” has also resulted in the use by MTIC traders of counterfeit cargoes and wholly fictional cargoes existing only on paper. Why pay a large sum for real goods to trade when a high taxable turnover can be achieved either just on paper or with worthless counterfeit consignments? There is little doubt that the insurance industry has fallen victim to claims in respect of such shipments albeit that this is difficult to quantify as the proof disappears along with the alleged cargo.

20. The prevalence of these related crimes mirrors exactly the level of MTIC fraud and this will be borne out by statistics from EU law enforcement agencies. In London this will be predominantly the figures from the Metropolitan Service and in particular, records held by Operation Grafton, an intelligence unit specialising in high value freight crime associated with London Heathrow Airport (where the majority of the relevant specialist freight companies are located).

21. The insurance industry saw a high level of claims in respect of the robbery or hijacking of mobile telephones and CPUs between 2001 and 2003. The levels diminished somewhat with the introduction of “Joint and Several Liability” and then exploded in 2005–06 as it became apparent that action by traders (the so-called
“Bondhouse” case in the European Courts was likely to result in a finding against HMRC (in respect of its Joint and Several Liability Orders).

22. Since the closure and liquidation of First Curacao International Bank (de facto removal of financial services from mobile phone and CPU traders) and extended verification of VAT returns by HMRC, the wholesale bulk trading sector has been almost completely halted. Coincidentally, the hijacks and armed robberies have also stopped and there is no shortage whatever in the supply of these goods to consumers.

23. Measures proposed by the European Commission (cross-border liaison and cooperation etc) are all helpful in clamping down on this fraud but have no realistic chance whatever of representing real progress toward stamping it out. The simple truth is that for as long as a situation exists where a non-governmental entity is entrusted to collect tax revenue and pay it over periodically to The Exchequer then somebody will always abuse the process for their own fraudulent gain. Some traders who collect VAT will continue to disappear with that public money.

24. The use of databases of IMEI or other identifying references on goods in order to identify repeated and circuitous trading of the same items has limited benefit. It is likely to deter the MTIC trade of items such as mobile telephones or technologies such as iPods and multimedia devices because it is relatively difficult to alter the identification numbers which appear both on packaging, on the casings of the items and in their software or firmware—requiring them to be laboriously reprogrammed.

25. However, in order for revenue and law enforcement officers to monitor fully these items it is necessary not only to record the identification on packaging but to open the packages and extract the identification numbers from the equipment software. This is because of the prevalence of counterfeit packaging systems mainly in Dubai and the Far East (where coincidentally most MTIC rings begin and end). This level of inspection will be difficult if not impossible for authorities to implement.

26. If it were achievable then these identification databases may deter the MTIC trade in phones and other consumer devices because of the overwhelming effort required to avoid detection. It would not however deter the MTIC trade in computer processors (where the largest illicit profit is to be made, owing to the value of these individual items and their low volume/weight). CPU’s are traded in bulk cartons typically carrying 315 units each. That is as much as GBP63,000 in each 10kg carton. Each one of these cartons has only one readily available identifying mark—a “lot” and a “box” number printed on an adhesive label fixed to the shipping carton.

27. I am aware of MTIC operations where CPU’s are imported from Dubai or the Far East and pass through a chain of transactions which includes a “missing trader”. The CPU’s eventually arrive at a UK purchaser who removes the processors from the shipping carton which he retains, empty, as evidence to any HMRC investigation that he is a domestic “end-user” of the CPU’s. In fact the CPU’s are exported back to the Far East in plain boxes where they are repacked into counterfeit Intel or AMD cartons with counterfeit “clean” lot and box number labels before coming back into the UK. MTIC ring. This example is an addition to the more customary and simple export out of the UK (achieving a VAT reclaim) in the original packaging which is then replaced with a clean identity in the Far East and sent back around the carousel.

28. The system of reverse charge is a near-perfect mechanism for stopping the fraud because traders are not able to collect the VAT in the first place. In effect the only type of business likely to be collecting VAT, under a reverse charge mechanism, is a retailer selling goods in small individual transactions to consumers. These tend to be large, stable businesses with little in the way of tax-fraud risk-indicators. Taxable sales to consumers are too difficult to “engineer” and too laborious and slow to be of interest to career fraudsters.

29. However the system of reverse charge, if it is to succeed, must be applied to all taxable transactions and not simply “specified goods”. I have evidence of traders in mobile telephones and CPU’s moving away from these goods into items not envisaged by the reverse charge proposals.

30. Such goods include cosmetics where traders are registering their own brands and patents so as to bestow a high taxable value upon a relatively worthless cosmetic preparation which can be purchased from chemicals suppliers in bulk. These generic creams are then cheaply packaged with the artificial branding and sold at exorbitant “paper-prices” for the purpose of MTIC fraud. As these goods do not carry serial or other identifying numbers or reference so the risk of detection is extremely low. It also puts MTIC frauds within reach of criminals or aspiring criminals who could not afford to acquire expensive cargoes of consumer electronic goods or who were not prepared to steal such goods from another party.
31. Other examples of the evolution of the fraud include the use of bottled mineral waters (actually bottled tap-water) with an artificially inflated brand-value and “fashion” goods where garments are purchased from Southeast Asia at very little cost and given a “fake-brand” makeover before being used as MTIC cargo. As these tactics increase so the possibilities for easy money-laundering are obvious!

32. By far the most worrying recent evolution of MTIC fraud involves the use of what are purported to be rare or unusual metals or chemical substances with artificially inflated values as MTIC trading goods. For instance I have been asked to consider an assessment of the risk in transporting what was described as a rare non-radioactive isotope of copper, much prized as an analytical reference material in laboratory testing applications. The value of the material was said to be GBP6,000 per gram but investigations proved that this was a readily available non hazardous substance available for purchase at between EUR5 and EUR7 per gram. The company seeking a risk assessment of the carriage of this material was a freight forwarder who until that time had specialised in the carriage of mobile telephones and CPU’s.

33. I consider that MTIC fraud has become the largest growth criminal industry that Europe has seen in recent years and that the practitioners of it will not stop if there is the slightest prospect of their activities continuing. The move towards using merchandise with little or no distinguishing marks or references that would expose the circular trading suggests that the only e continuing. The move towards using merchandise with little or no distinguishing marks or references that would expose the circular trading suggests that the only effective counter-measure is to take the collection of tax, to the maximum possible extent, away from potential fraudsters. A universal reverse charge mechanism seems the obvious solution.

15 January 2007

Examination of Witness

Witness: Mr Royston Ford, Cunningham Lindsey Marine, examined.

Q270 Chairman: Good morning. May I welcome you to this meeting. It is the Missing Trader Fraud inquiry; the session is on record, is being recorded for a webcast, and you will also receive a transcript of what is being said during this session. Can I first congratulate you on your written submission to us, which is a very detailed insight into what is going on and certainly arouses our interest. If I may I would like to ask you whether you think that missing trader fraud is a bigger problem in the UK than in other European countries, or are we better at detecting and measuring it?

Mr Ford: My feeling is that the UK is not suffering to any greater extent than many of the other larger European economies, and I am thinking particularly of France and Germany. We have become better at recording and detecting it but my experience has been that there has been perhaps a reluctance to face up to the scale of the problem and that estimates from HM revenue and customs have been somewhat on the low side. Those estimates have ranged dramatically from £2 billion to £5 billion to £7 billion and similar figures. There seems to be little consistency in the numbers that come forward, and I have noted that Eurostat in July of last year recorded dramatically higher figures than HMRC ever have. For the UK they estimated eight billion euros, a similar figure for France, and nine billion euros for Germany, so I see a variety and a range in the figures; I think they are becoming better, but the true extent I am not sure we have discovered.

Q271 Chairman: You have placed great emphasis in your written evidence on the reverse charge solution. Could you tell us why? Also, if that were implemented, even from what you have said it seems that the one thing they are good at is mutation, so why do you think they will not get round that?

Mr Ford: I believe that if a reverse charge is implemented on specified goods then these fraudsters simply will mutate the fraud to other product, and I see no reason to think they should stop simply because their favoured devices and goods are no longer available to them. For this reason I think the universal reverse charge is the most likely variant of reverse charge to be successful and, as we may discuss later, we have come across in the insurance industry already mutations of the frauds to other goods, and we can expect that to continue, I believe.

Q272 Lord Kerr of Kinlochard: Why do you think the mobile phone and computer chip sectors have been particularly targeted? Is it a recent phenomenon fuelled by high value/low volume consumer goods, or was it inevitable that something like this should build up? Has it been building up since the first introduction of VAT-free intra-Community trading?

Mr Ford: Yes. I believe it has been a steady increase since the introduction of the intra-COM system in the early ’90s. Obviously high value/low volume goods are the favoured commodity for VAT fraudsters because of the ease of moving them around, and the greatest potential VAT recovery for them on each transaction. Over the years we have seen initially clothing, in the early ’90s—fashion garments were a very popular ruse for carousel traders but at a much smaller level; in the mid to late ’90s we saw computer
memory as a much favoured vehicle for carousel fraud because of the sheer price of that particular product at the time; and I believe now they have settled with mobile phones and CPUs simply because of the availability and the relatively high price. Mobile telephones were not so universally available until around the late 1990s when the price came down, manufacturing shifted to China, the volumes increased, and the same of course for CPUs, so I think it is a combination of availability and, as you say, the high value/low volume.

Q273 Lord Kerr of Kinlochard: Towards the end of your fascinating memorandum you describe a number of other groups of commodities where, in your view, it is not simply a risk of the fraud migrating from mobile telephones to them, but it is already happening in your view. Would you like to say any more about that?

Mr Ford: Yes, indeed. Obviously purchasing genuine mobile phones and CPUs is one way to perpetrate the fraud. It is much better if one can use counterfeit goods, or even non-existent goods, or find a commodity that has a low intrinsic value upon which you can imply a much greater value. So as the pressure has increased on mobile phone and CPU traders we have witnessed some of the same companies who have been trading phones, CPUs, switching to pharmaceuticals, which may or may not be real goods, they could be counterfeit; we see them switching to designer clothing, where they register their own patents and trademarks and then claim these goods and these brands to have a high value, when, in fact, they are relatively worthless Chinese cotton T-shirts with a home-made label put on them. Cosmetics is one that concerns us greatly because, as we see on television every day, miracle cures, Q10 creams, lipid this and lipid the other—these base commodities at almost no cost, which is much more attractive than actually purchasing real mobile phones and CPUs which, of course, genuinely be purchased at relatively low cost, bottled or potted at low cost and, again, one’s own trademark applied to them followed by a claim of extreme high value. In this way fraudsters can acquire high paper value commodities at almost no cost, which is much more attractive than actually purchasing real mobile phones and CPUs which are, of course, genuinely expensive. We have been doing risk management work for a number of UK insurers who have been covering mobile phone traders, and of late they have asked us to investigate these companies for the potential exposure to fraudulent trading, and in interviews with the owners of the companies these people have discussed moving into cosmetics, beauty products, mineral waters, clothing. Computer software is another excellent example. In one face-to-face interview the owner of a mobile phone trader indicated that he was becoming a software trader with a new whiz product, an accounting system described as “Web Accountant”. A quick search on the Internet showed this was an open source programme, not fully developed, freely available with no commercial value, yet he was selling on paper this product at several hundreds of pounds a unit, and that, of course, is a simple CD-ROM in a box.

Q274 Lord Kerr of Kinlochard: We took evidence from the Treasury who gave us the clear impression that the Government believe that carousel fraud in mobile telephones is on the way to being defeated and that the incidence is now going down. Would you like to comment on that? If your evidence is correct then the chances are, if the Government has cracked down successfully on this particular fraud in this particular sector, mobile telephones, fraud will migrate to another sector.

Mr Ford: Yes, I believe it will, and in those examples we have already seen this happening. I am not a lawyer, my Lord Chairman, but I have concerns about the Government approach and the Customs approach to this problem and what they describe as a crackdown on fraud in fact is a crackdown on the trade. Very little has been done to stop the fraud and prosecute the fraudsters, but the trade itself has been stopped. Now, how long the Government might sustain that, because there is a concerted legal action for traders, would take somebody with more legal expertise than me to say, but I have concerns that this may not be a long-term solution.

Q275 Lord Cobbold: In your memorandum you say that MTIC fraud has become the largest growth criminal industry that Europe has seen in recent years. In your view is this fraud a co-ordinated and sophisticated attack on the VAT system by organised crime, or is it a series of opportunities being exploited by casual fraudsters?

Mr Ford: I would suggest that it is a combination of both. We have seen examples of what might be classed as casual fraudsters setting up relatively simple carousel rings. They tend to be caught fairly easily and fairly quickly because they stand out; they are too close, they are too amateur, it is too easy to link the various trading companies together, so that relatively rare casual carousel trading exists. There is also the aspect of one hit wonders, as I call them; companies or individuals that hold themselves out to be VAT-registered, or alternatively steal the identity of a VAT-registered company in order to make often a very small number of transactions nonetheless stealing VAT in the process, but that kind of deception, appearance of VAT-registration, does not last very long so these tend to be transient criminal operations. But the vast majority of the carousel trade that we see is most certainly characterised as serious and organised and generally from outside of...
Q276 Lord Cobbold: What sort of numbers of serious criminal fraudsters are we talking about? Two or three big gangs? Twenty? Fifty or a hundred?

Mr Ford: My sense of this problem is that there are probably between 10 and 15 serious organised co-ordinators of VAT fraud, with a similar number of individual significant players who are in it for reasons we cannot establish, but it does appear to us that the fraud revolves mainly around a number of freight forwarding companies because, of course, a tame freight forwarder is essential for perpetrating this type of activity.

Q277 Lord Steinberg: I was taken particularly by Lord Kerr’s question to you in which you indicated that you do not think the Government is doing enough to try and stamp out this type of criminal activity. I have been an advocate for a long time of concertedly any comparatively low-priced commodity can be used to do it, so if the crackdown is taking place at the moment according to the Government but not according to your mobile phones, will it switch to cosmetics, will it switch to cheap electrical goods and so on ad infinitum, and is that problem not going to be resolved only by breaking up these gangs who, according to you, are already known as active criminals in this area?

Mr Ford: Yes, my Lord, I think the question of rattling cages, or the objective, is an extremely good one. When I mentioned freight forwarders, these are the places at which the fraud becomes most apparent, where we see small freight forwarding companies in west London who are chartering cargo-carrying aircraft three times a week to carry pallets of mobile phones to and from Dubai. It is in those offices where the paperwork begins and ends and at their branch offices in Dubai, where the other half of the fraud is, of course, being perpetrated. These are very obvious; very visible targets. On the face of it the problem is that they appear to be doing nothing wrong—they receive instructions, they ship mobile telephones: “We have no knowledge”, they say, “of any wrongdoing. We are simple freight forwarders”. It needs concerted investigation by law enforcement to uncover and prove the conspiracy, yet this is not being done. The trade has been paralysed by the withholding of VAT refunds and the denial of banking services, to mobile phones and CPU traders; almost no other business is affected by this. So it is abundantly clear that these people will migrate to other untargeted commodities.

Q278 Lord Steinberg: If I can quickly follow up on that would you advocate, then, the serious fraud squad going into some of these freight forwarders? When you say that planes are being loaded up three times a week, it is absolutely colossal.

Mr Ford: It is.

Q279 Lord Steinberg: Surely to goodness the Serious Fraud Office, which unfortunately has not had a great success rate so far, or an organisation like that that should go in and take apart one of these places here and simultaneously try and deal with the opposite number abroad—which might be rather more difficult, I accept, but is that not the way to try and put fear into these gangs?

Mr Ford: It most certainly is, my Lord Chairman. The carousel traders have been very good at putting distance between the various nodes of the carousel networks, so that any one party appears to be entirely unconnected to any earlier theft of VAT or any conspiracy, so proving a criminal act on the part of any one entity is extremely difficult and it needs resources. In some ways it may be the resources of the intelligence services as well, where we have the overseas networks and potential links into the terrorist funding. I do not know what facilities or resources HMRC have available to them for this type of surveillance and intelligence in proving the conspiracy connecting the various nodes. It is something that could well need more input from law enforcement, yes.

Q280 Chairman: Could you tell us which forms of co-operation between the various government agencies might produce the best result? We have heard there is not enough co-operation between agencies. Where do you think it ought to be pointed and targeted, this co-operation, and by whom?

Mr Ford: I believe that the most effective co-operation comes through linking HMRC intelligence units and police intelligence units. This has had enormous results in the Heathrow area where much of this is perpetrated with the work that Operation Grafton, part of the Specialist Crime Directorate, have been doing with HM Customs in Staines where they have a number of intelligence operations running. If it were escalated to the likes of the Serious Fraud Office or a specialist unit created to look at this...
overlapping between tax and commercial crime and fraud, and, of course, the real world crime, this would be beneficial. We have had situations where armed hijacks, armed robberies, occur, or warehouse robberies, ram raids, intimately connected with VAT carousel fraud, and that crime will be reported to the local police station, the local CID officers, whom we speak to, and as soon as one begins to explain what lies beneath this apparently simple crime, how complex it is and how much work it might need, you can see their eyes glazing and the interest waning and the papers closing almost before you. It needs investigative law enforcement personnel with the time commitment and the resources because it is extremely complex.

Q281 Chairman: Do you think HMRC are directing their attention perhaps wrongly? Should they be shutting down banks rather than concentrating on extended verification?

Mr Ford: Banking services have been denied in effect by all the UK banks to mobile phone and CPU traders which led all of them to First Curacao International Bank in the Dutch Antilles, which has now been closed it has been widely reported, and I understand that has produced some extremely interesting results on the money trail and the money laundering, so quite how these businesses will continue to trade mobile phones and CPUs when they cannot get financial services I do not know. Right now there is no banking in the mobile phone and CPU trade so there is nothing particularly to investigate.

Q282 Lord Cobbold: Is the only solution to this problem a complete restructuring of VAT?

Mr Ford: It is my opinion, and I do not hold myself out as an EU tax expert, that it does need a complete branch reform of the EU VAT system. We have to move away from a system of VAT-free intra-Community trade. This is what drives the fraud, and it will always drive the fraud. The fact you can obtain something without paying VAT, you sell it, you receive VAT and you are trusted to hand it over to your national government. It will always attract criminals. It always has and always will.

Q283 Chairman: It was obviously alarming to hear you suggest that some might find their way into terrorist funding. Do you have any reason to know of the antiterrorist squads investigating any particular VAT fraud?

Mr Ford: No, I do not know of any specific investigations but I have given evidence in discussions to police officers and I have been aware that that information has been of serious interest to other agencies. These are personal fears, and I speak as somebody whose partner is Muslim and who is not prone to Islamaphobia, having come face-to-face with interviews with traders in the Middle East who are British nationals, Muslim, and having had disturbing conversations along the lines that one would certainly characterise as more extreme religious views, which were somewhat disturbing to me.

Q284 Chairman: Mr Ford, can I on behalf of this Committee thank you for the clear way in which you have answered us. If there is anything you finally think we have not touched on that you would want us to know, I will give you that opportunity now.

Mr Ford: No. I think we have had an interesting discussion.

Chairman: Thank you.

Memorandum by the Federation of Technological Industries

INTRODUCTION

This letter is submitted in response to the call for evidence issued by the Select Committee of the European Union, Sub-Committee A (Economic and Financial Affairs, and International Trade) to support its expanded inquiry into the fight against fiscal fraud and the issues surrounding Missing Trader VAT fraud.

The Federation of Technological Industries (FTI) represents companies trading in telecom products and computer components (traders). Much of the trading activity is in the grey market of surplus stock released onto the market by authorised distributors and wholesalers. It is a legitimate industry which supports significant employment across the UK, contributes tax revenue (PAYE, NI and Corporation Tax) to UK PLC and creates lower prices for UK consumers.

Since 2002, the industry has been on the receiving end of extremely aggressive treatment by HM Revenue and Customs (HMRC). HMRC are very concerned about large losses of VAT as a result of carousel or missing-trader fraud, but has found it difficult to identify, and even harder to successfully prosecute, the firms or individuals directly responsible for this fraud. This is demonstrated by the dismal success rate of prosecuted fraudsters against the magnitude of the alleged MTIC VAT fraud. As an alternative to the difficult task of catching fraudsters, HMRC have adopted the simpler approach of discriminating against the softer target, the
exporter, who just happens to be the organisation furthest away from any fraud and most likely to be a completely innocent/legitimate trader.

HMRC have pursued, and are enforcing, a policy of disruption against the trade in general. This policy includes putting pressure on banks to close traders’ accounts, cancelling VAT registrations, imposing special VAT periods, carrying out extended verification checks on “exporters”, delaying legitimate VAT repayments and targeting freight forwarders. The FTI firmly believes that the aim of HMRC’s disruption policy is to close down the industry. To quote the Paymaster General, Dawn Primarolo, “it is perfectly OK to penalise legitimate businesses by withholding VAT refunds, because that is much better than making payments to the guilty”.

The FTI welcomes the opportunity to contribute to this inquiry and hopes that the negative impact of HMRC actions on legitimate traders will be addressed.

We have circulated your call for evidence to the whole industry, not just FTI members, and replies have been consistent. We had 220 visits to our on-line questionnaire and the responses received have been used to compose our answers to your key questions.

RESPONSES TO SPECIFIC QUESTIONS

1. **What impact does this fraud have on the internal market?**

One of the anomalies of this type of fraud is that it encourages activity in the grey market which in turn results in increased buying power for main distributors and wholesalers. This improved buying power is normally reflected in distributors reacting to high street competition by lowering consumer prices. So indirectly MTIC fraud assists the industry and creates lower consumer prices.

On the other hand, UK PLC as a whole will suffer if the scale of VAT fraud is as great as alleged by HMRC. With this level of loss many public services are surely losing out. However, destroying the industry is not the answer as the overall loss to UK PLC will not be resolved as it will result in:

(a) higher high street prices, which will assist in inflation increases, and

(b) losses of other taxes as large numbers of jobs are lost and companies close with obvious losses of Corporation Tax etc.

The most serious impact is the effect HMRC’s activity is having on a legitimate industry:

(a) they have removed a company’s basic right to trade with legal certainty,

(b) with the introduction of Joint and Several Liability in 2003 they imposed an additional burden on legitimate traders, and

(c) withholding repayments indefinitely from exporters whilst fraudsters are allowed to make off with their spoils.

Missing Trader Fraud seems to have become a “catch-all” for HMRC justifying delaying input tax repayments and attacking legitimate, innocent traders on a broad front.

There is an urgent need to define the fraud, as HMRC now seem to start with the presumption that the whole industry is fraudulent. The scale of the problem is quantified with statements relating to “attempted fraud”, “possible fraud” and “losses to the Revenue”. Being the only ones with access to the true picture maybe HMRC should be charged with providing a comprehensive definition of the problem thus allowing innocent traders to make commercial decisions on how they trade. Denying British companies their right to legal certainty is unjust.

Withholding genuine repayments whilst carrying out extended verification process has had a major effect on the industry, with companies having to close and lay off staff.

The fraud and HMRC’s activities have created an atmosphere of distrust amongst traders with the suspicion that “everyone else” is fraudulent and there is no legal certainty that honest traders will not be discriminated against.
2. What are the measures currently applied in the UK and other Member States to combat this fraud and what are their weaknesses?

In the UK the 2003 Finance Act introduced Joint and Several Liability which should prove an effective deterrent to the fraudsters and anyone involved in the fraud. Indeed the Advocate General commented on ways of tackling carousel in his judgement in the joined cases of Optigen, Fulcrum and Bond House as follows:

“The United Kingdom seems to envisage combating carousel fraud—or at least dispensing with the problems it poses—by limiting the scope of the VAT system. To my mind, the Court should not consent to this approach. It would drastically shift the burden of the problem from the tax authorities to the private sector, at the expense of legitimate trade and the proper functioning of the VAT system. Moreover, it would deter Member States from taking appropriate measures against carousel fraud. In this regard it is particularly worthy of note that where an activity falls within the scope of the Sixth Directive, that does not mean that Member States lose their power to take action against it. (37) In fact, Article 21 of the Sixth Directive gives Member States the opportunity to introduce joint and several fiscal liability. A taxable person can accordingly be held accountable for the payment of VAT due by his co-contractor, if he knew or should have known of his co-contractor’s fraudulent activities. (38) Several Member States have adopted measures of that kind against carousel fraud”.

However, HMRC have not implemented this legislation although they have required traders to comply with the additional checks and procedures mentioned in Notice 726. This Notice contains the only published guidance giving any assistance to any entity wanting to trade in the industry. Instead they appear to be focussing on the “means to know” theory which is being cited from the European Court case known as “Axel Kittel v Belgium, Belgium v Recolta Recycling SPRL (Judgement of 6 July 2006)” the outcome of which is being misinterpreted for their own objectives. There are no guidelines in place for such a test and HMRC have issued no guidance on how they perceive this test should apply or indeed what steps a trader can take to protect himself.

HMRC have adopted an aggressive policy of denying all repayments (some for over a year) to any company remotely associated with the industry, whether the repayment is trade related or not. These actions appear to have no legal support either in European VAT legislation or the UK VAT Act. HMRC appears to believe in the principle of “the end justifies the means”. Their aim is to eradicate fraud, but they do not seem to care about collateral damage.

HMRC are ignoring recent ECJ judgements requiring them to act reasonably and proportionately in the enforcement of their powers/policy.

HMRC continuously generate negative publicity, with little, if any, facts to support it, concerning Missing Trader Fraud put pressure on banks to refuse facilities to the industry and close accounts with little notice, even if some accounts have been in operation for a good many years. It is for this very reason that traders ended up with overseas bank accounts even though publically, HMRC put a very different spin on events.

This approach is having little effect catching the fraudsters.

Measures currently taken are to consider all companies dealing within the telecommunication and computer component wholesale industry to be guilty and therefore honest businesses are treated like criminals. A blanket policy is not effective in dealing with the individuals involved in fraud.

The current policy is not a measure to combat fraud, it is a measure to balance the Treasury’s books.

Other EU countries, for example the Netherlands, Germany and Denmark, have a more targeted approach of hounding the missing traders and prosecuting them. This punishes the criminals and signals the end of the fraud. This is a more productive approach to the easy way out opted for by HMRC.
27 February 2007

3. The Commission has suggested measures including increased cross-border liaison by tax and law enforcement authorities and Governments, improved risk management, and mutual assistance by Member States wishing to recover unpaid taxes. Are these mechanisms adequate?

Any measures to recover unpaid taxes should be welcomed, although it will be important to ensure that the effect on legitimate trade is minimised and the interests of the innocent are protected.

The Fraud is cross-border so it is imperative Member States work together. With access to modern technology cross-border co-operation should be quick and efficient. Facilities should also be provided to give genuine traders “early warning” of possible fraudulent/suspect activities.

4. Are Member States, within the context of the internal market and the globalised economy, capable of fighting individually against this fraud or is it right for the Commission to bring forward proposals on their behalf?

The fraud is being carried out in a number of Member States and requires co-operation between individuals in different Member States. It is therefore obvious that co-operation between the relevant authorities in all Member States is required to combat the fraud.

It is more efficient to fight it collectively.

The Commission must bring forward the proposals. Individual Member States cannot introduce co-operation without central legislation.

However, as other Member States have vetoed Britain’s request for reverse charging it seems obvious that agreement may well never be agreed upon.

The Commission should bring in proposals that apply equally to all members.

5. Is it necessary to simplify or restructure the VAT system to prevent this type of fraud? If so, how might this be done?

VAT is a unique tax as it requires companies to collect and account for it for no direct benefit to the individual company, in fact in some industries the potential problems associated with it is a deterrent to trading. It is obvious that it is time to review this system.

It is obvious that the more people involved in processing the VAT within the current system, the more likely it is that there will be fraud.

To prevent this type of fraud, the VAT system needs to either be the same rate all across the Member States and no zero rating allowed, or completely removed. Any other variation or restructure will simply allow the mutation of the fraud. It will still continue in one form or another.

6. Does the adoption of measures to fight VAT fraud at the Community level undermine Member States’ control over the functioning of national fiscal systems?

If the measures require harmonisation of VAT between Member States this would be seen as effecting control over the functioning of national fiscal systems but this should not stop the Commission examining ALL options and reporting on its findings.

A report should be commissioned to carry out an overall review of the VAT system. It appears as if the current system was thrown together too quickly and generated a new litigation industry with 1,000s of tribunals and High Court cases each year, many requiring referral to Europe for clarification.

7. What would be the benefits and costs of moving from the current destination system to an origin system?

Companies would not need to account separately for goods sold domestically and those exported. It would reduce the type of fraud in question as long as VAT rates were harmonised across Member States.

The cost of such a change would undoubtedly be substantial for industry and governments alike. It could further result in considerable confusion, many legitimate businesses could find it tough to cope with.

The benefits are that the current type of fraud will be removed. The costs are that simply new types of fraud will emerge. The answer is to provide more resources at State level and increased cross border partnerships.
However the loss of VAT will not stop. Fraud will move from one side to the other. Companies will not go missing anymore, false declaration of VAT numbers and purchasing of products at zero rate could increase dramatically.

**ADDITIONAL COMMENTS/SUMMARY**

You will note from the summary of responses to your questions that most traders support the fight against fraud. However, we are most concerned about the tactics employed by HMRC which targets legitimate traders rather than the fraudster.

It appears that HMRC measures have virtually stopped VAT repayments and the extended verification process has caused a great deal of hardship resulting in many companies closing with loss of revenue to the economy and unemployment.

Although we fully support proportionate actions to combat fraud, we would hope that the policy does not advocate penalising honest businesses.

Please note that on 9 June 2006 we met with Mr Mike Eland, Director General, Enforcement & Compliance at HM Revenue & Customs to discuss the various issues concerning the industry. In September 2006 we wrote to him and Jonathan Healey requesting an urgent meeting to discuss HMRC’s Extended Verification process and the detrimental effect it was having on the economy. Unfortunately, he was not prepared to agree to a meeting, but preferred to reply in writing. The key issues were:

- How can legitimate traders be safeguarded in the extended verification process? Whilst HMRC are entitled to a reasonable time to verify transactions which qualify for input or output tax, withholding input tax claims only, and for periods now exceeding 12 months without any Judicial control, is clearly contrary to our democratic and legal principles.

- The potential impact of current HMRC actions on the UK economy.

- The inability of the Court System to cope with the large number of Judicial Reviews, and the consequential hardship this will cause.

- Safeguards to ensure the basis for raids on businesses are credible.

Many companies filed claims for damages following the “non economic activity” policy and the subsequent ECJ decision in Bond House. There is every chance that similar claims will follow once the Courts are allowed to scrutinise the current policy of HMRC who are guilty of playing the judicial system to their advantage. Whilst publicly acknowledging that traders have no current option but to file for judicial review, those that take this expensive and time consuming option find that they are given a decision just before their hearing so that their case is referred back to the VAT Tribunal thus delaying the process even further. Sooner or later these actions will be scrutinised and traders who have done no wrong will be seeking compensation.

**15 January 2007**

**Memorandum by Dr Michael Cheetham**

My company Bond House Systems was one of the largest computer component distributors in the UK. We had been trading for approximately 10 years and had just been appointed an official AMD reseller for the UK when the might of HMRC descended upon us in a creative and novel approach to try and find a solution to the MTIC problem. As Customs own policy papers now show, that solution was to crush the export companies and deprive them of their cashflow in an effort to strangle the entire affected trade sectors. That Policy has continued to this day in one guise or another and as the trade and loss figures show it simply has not worked (apart from it being wholly illegal).

In 2002 HMRC sought to solve the growing MTIC problem by suspending the VAT repayments to legitimate trading companies such as mine and the fight went all the way to the European Court of Justice who declared the action unlawful. The litigation has reached a successful conclusion now and I would not wish to waste the valuable time of the Select Committee with my plight. It is far more important to look towards the future and to sort this problem out so that this country stops losing the £3–8 billion and legitimate companies trade can trade once again free from the Armageddon that is no been inflicted on them in an effort to suppress the high percentage of illegitimate companies and those that are just milking the system.

For the last four years, I have developed and refined a near perfect solution to the EC MTIC problem and the litigation between my company and HMRC has prevented me from being able to present this to HMRC. Over the last three years, we have been unable to meet on three separate occasions and sadly the UK may well have
lost over £10 billion in that period that I may well have been able to prevent. Despite being a simple and clear concept to understand, it is highly effective and could be implemented at either UK or European level without any further legislation. It would not however function if reverse charging was introduced indeed there would be no need for it.

Reverse charging is not however without its problems. It will create two entirely new frauds—end seller fraud and end user fraud. End seller fraud will be where the trader will receive the goods from an “RC” VAT free chain and will sell to the public (eg on EBAY), charging the VAT as prescribed but either pretending to have sold the goods VAT free onto another RC company or simply go missing with the VAT. Using the 17.5 per cent VAT, this end seller fraudster will be able to discount the price (say 7.5 per cent) to make the goods attractive to the public and retaining the extra 10 per cent for themselves. Whilst end seller fraud does not have the same perpetual capacity to grow as carousel fraud, it is much harder to detect because this time the fraudster is located at the fat end of the wedge. Legitimate companies selling to the public on the High Street eg Carphone Warehouse will not be able to compete against the End Seller fraudster with their 17.5 per cent margin to play with.

“End User” fraud is another problem where people will pretend to be VAT registered to secure goods at VAT free prices when in fact they are not VAT registered at all. This may grow into a small but significant problem. Once again this fraud is located at the fat end of the wedge and its detection all the more difficult to undertake.

The biggest problem with Reverse Charging is that the UK is in reality saying to the EU . . . Please can we have a special permission to rid ourselves of the problem by having no VAT in these supply chains and we will “dump” our problems on you. At present, most of the organised crime setting up and running the Missing Trader companies are domiciled in places like Dubai, Switzerland and the Far East. If the UK is granted the Derogation these people will simply come to the UK to operate. Why send the goods three days to Dubai, one day there and then three days back ie a seven day turn of the Carousel when you can operate the fraud from the UK and do 10 frauds in a day.

The goods will pass from a missing trader chain in France, to the UK traders who will then sell the goods to a Missing Trader chain in Slovakia who will sell them back to the UK who will then sell them to Germany and so on.

What is so important to understand About Reverse Charging (RC) is that an anomaly of the VAT system called “Triangulation” or Article 22(8) means that goods can actually pass from the Missing Traders in France, directly to those in Germany. There is no need for the goods to come to the UK and the UK simply handles the paperwork (invoices) and the payments. Article 22(8) is a perfectly correct and normal trading system that will be exploited by those who will come to the UK to mastermind the fraud in other member states from here.

The UK will simply put up its hands and say “we don’t have a problem because we don’t have VAT anymore so we don’t have the fraud” and meanwhile we inflict the fraud on an accelerated scale on every other EU state. Do we really want to propose this as a solution?

The final and equally important problem with the RC derogation as it stands is that it covers only a small range of high value commodities. The fraudsters are highly experienced and now educated and throughout the last 10 years they have sought to counter and avoid whatever tactics HMRC have sought to try and enforce. The fraudsters simple solution to RC is to move into other goods and services. I am already receiving many reports regarding the emerging problems in the pharmaceutical sectors (high value drugs), medical equipment, plasma TVs, children clothing and even sugar.

It will not be possible to return to the EC and ask for a never ending list of products to be added onto the provisions. The fraud will be displaced into other goods and that is all. The solution that I offer takes this into account and does not require derogation of any kind. It can be implemented nearly immediately.

I have termed a second solution which would prove an effective solution certainly for the UK and the vast majority of other EU members “Base Rating”.

**Base Rating**

The MTIC problem is a very simple one at its heart and no matter how complex the fraudsters schemes, cloaks, diversions and counter measures become, the fraud occurs because goods are zero rated between EU member states. That is it. That is all that matters. If you stop this. You stop the fraud.

The fraudster usually drop the price down (using the VAT margin) to at or below market prices to catalyse the sale of the goods by making them attractive to purchase.
The current VAT systems was always intended to be a temporary one and in its early days of development the options of “point of origin” tax or “harmonisation” were explored. I will deal briefly with the problems of these and why they were not adopted during the infancy of the EU VAT system.

**Point of Origin Tax**

This involves paying the VAT of the EU suppliers country and then being able to offset this tax against UK sales as input tax.

**The current VAT rates in the European Union**

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<thead>
<tr>
<th>Country</th>
<th>Standard Rate</th>
<th>Food Rate</th>
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<tbody>
<tr>
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<td>20</td>
<td>10</td>
</tr>
<tr>
<td>Belgium</td>
<td>21</td>
<td>6</td>
</tr>
<tr>
<td>Denmark</td>
<td>25</td>
<td>25</td>
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<tr>
<td>Finland</td>
<td>22</td>
<td>17</td>
</tr>
<tr>
<td>France</td>
<td>19.6</td>
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<tr>
<td>Germany</td>
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<td>7</td>
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<tr>
<td>Greece</td>
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<tr>
<td>Ireland</td>
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<td>Italy</td>
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<td>Luxembourg</td>
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<td>Netherlands</td>
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<td>Portugal</td>
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<tr>
<td>Spain</td>
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<tr>
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<tr>
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Thus a VAT registered UK trader purchasing from Germany would buy a net £100 item at £100 + £16 (VAT)—Total £116. If he sold this in the UK, for £102 net (2 per cent profit margin), he would then charge £102 + £17.85 (VAT)—Total £119.85.

The UK VAT return would reflect these two VAT amounts (an EU input tax and UK output tax) on his VAT return and the UK Trader would require to account for the difference of the VAT, in this example pay £1.85 to the UK government.

The major problem with point of origin tax is that it penalises intra EC trade against those member states with higher VAT rates than the purchasing country. Why would a trader want to purchase from Denmark goods with a 25 per cent VAT uplift on them when the same goods could be purchased for a similar price at 15 per cent VAT from Luxembourg. The 10 per cent difference in cashflow is of massive significance to a trader, especially as they may have to wait up to three months for a refund if the VAT imbalance is negative.

It is interesting to note that many internet companies have now chosen to base themselves financially in Luxembourg (selling to end users and thus charging full VAT of the country of origin) in order to charge the public 15 per cent end user VAT. This trade displacement effect would be amplified on a massive scale were Point of Origin tax to be introduced EU wide.

It was decided that this system would severely penalise the higher rate countries and so it never got any further. I do note that it is once again being considered by the European Commission as a possible MTIC solution.

My solution of “base rating” deals adequately with this shortcoming.

The second problem with Point of Origin tax is that it requires the individual EU member states to make necessary adjustments to tax volumes collected based on EC Sales and Intrastat figures. Any imbalance on intra EC sales tax collected must be adjusted at regular intervals. This is heavily reliant on the intrastat and EC sales being very accurate and up to date. Historically these collected statistics have been shown to be grossly incorrect, late and with a huge variation of controls and enforcement across the EU states. One can imagine Italy objecting to refund the UK any tax imbalance because their EC sales figures do not match ours or one of the newer EC member states (still coming to grasp with Intrastat) not being ready in time for the balancing deadlines.
The fiscal adjustments are based on:

1. the differential between individual volumes of the two-way trade between those two member states; and
2. the differential between those two countries VAT rates.

My solution of “base rating” reduces this problem but does not deal with it entirely.

**Harmonisation**

Once again, an easy concept and it was hoped in the early days that all EU members would adopt a single rate of VAT across Europe. At many of my lectures, it is one of the first solutions that audience members raise as a realistic solution. The problems of this are nearly too obvious for me to bother typing to you. Denmark and Sweden at 25 per cent are hardly likely to give up the extra revenue they receive now if they are asked to drop their rates to a more central EU wide 18 per cent. The government would take a 7 per cent drop in revenue from VAT overnight. Can you imagine the objections from the Electorate in Spain if VAT was put up to 19 per cent just to facilitate intra EC trade without MTIC problems. An immediate 3 per cent uplift in inflationary terms, just to solve MTIC.

**Base Rating**

This is my simplest solution to the MTIC problem. Instead of goods passing between VAT registered traders at 0 per cent VAT which facilitates the fraud, why not pass between member states at the lowest rate of any EU member ie 15 per cent.

Thus a £100 net sale from the UK to Germany would be £100 + £15 VAT. Between Italy and France the same €100 + €15 VAT. 15 per cent would be charged everywhere on intra EC sales or whatever the lowest VAT rate was within the EU. At present, I am not sure what rates Bulgaria or Romania intend to bring to charge next year.

There would be no imbalance in cashflow because the goods would be charged at the same rate across the EU and intra EC trade would be driven on a level VAT playing field by market prices and not VAT impaired cashflow.

The margin for MTIC fraud would be drastically reduced in most member states because based on 15 per cent base rate, goods sold in the UK at 17.5 per cent (so a maximum of 2.5 per cent for a potential fraudster) would leave no margin for the fraudster to either drop the price or make any profit themselves. Since legitimate traders normally expect a 2–4 per cent margin on their sales, the marketplace would not be receptive to the fraudsters goods and even if one sale did take place (in the EU members with much higher VAT rates), there would not be sufficient margins to make the carousels that we see nowadays turn a single revolution.

In the majority of member states such as the UK, a 15 per cent base rating of all intra EC sales (rather than the current 0 per cent) would see the fraud unable to operate. In those member states with the higher rates eg 25 per cent, their exposure would be significantly less ie 10 per cent.

Financial adjustments between member states would still need to take place monthly or quarterly to correct any imbalance in tax collected but in my concept of base rating this would simply be based on the differential between two way trade of those two countries. If German suppliers had sold £20 billion worth of VAT goods to the UK and the UK had sold £15 billion to Germany then the VAT adjustment would need to be refunded on the £5 billion imbalance.

These kind of adjustments already take place between EU members states on duty matters and the EC sales and Intrastat would provide the raw data on which these adjustments could be made.

“Base Rating” is so simple to define and introduce. One simply replaces the words “Zero rating on EC sales” throughout the Sixth VAT Directive with “Base Rating on EC sales” and defines “Base rating” as the lowest rate of any member state.

Base Rating was the first solution that I devised and until four years ago, it was the best. It was in 2002 during a trip to the USA that I saw a very clever solution to tackle cross border fraud between Mexico and California. This led to the development of my second solution that I now call VLN. The fraud cannot operate and unlike the current HMRC tactics, it doesn’t suppress legitimate trade.
It would stop the fraud overnight and would work perfectly in the UK alone but would be absolute if introduced EU wide. It will work with any commodity unlike the derogation that has a limited range of products that it covers. I am sure the fraudsters already have a new list of products to exploit if reverse charging is applied essentially to chips and phones.

22 January 2007

Examination of Witnesses
Witnesses: Ms Angela O'Hara, Vodafone; Mr Fred Howarth, Federation of Technological Industries, and Dr Michael Cheetham, gave evidence.

Q285 Chairman: Good morning, to you all, and may I in particular welcome Angela O'Hara from Vodafone, Dr Mike Cheetham from Bond House Limited, and Fred Howarth from the Federation of Technological Industries. You are aware that we are looking into the question of missing trader fraud and we would like to ask you some questions. There are three of you so I am not going to invite each one of you for a statement; your submissions have given us a start and our questions, I am sure, are going to elicit the things we want to know. Can I begin by asking all of you, what has caused your industry to be targeted by MTIC fraudsters?

Mr Howarth: If I can begin on that, I think our industry is typical but not unique in being targeted in as much as we trade in high volume/high value commodities. Similarly the pharmaceutical industry has a very similar problem; if not as bad as our problem it is working its way towards that. So I would say it is the value of the product we deal in and the demand for the product.

Ms O'Hara: I think I echo those comments; it is really high value/high volume. It is a very fast-moving consumer goods market and I think that is really why it has been targeted.

Dr Cheetham: There was a legitimate market, and still is, which trades in chips and phones which are such high value. The grey market and parallel market, as it is called, are there to find excesses of product and fill demand for product, and it has to move very fast. If there are people building computer systems they need the chips the next day; if there is a production line running and it has run out of stock, those chips are needed for the next day. Thus it is a very fast, reactive market and this is ideal for the fraud.

Q286 Chairman: If I might direct a question to you, Ms O'Hara, has there been any impact on your business from extended verification and HMRC’s attempt to disrupt fraudulent trade?

Ms O'Hara: Most of our handsets are bought directly from the Nokias and the Ericssons, so there has been really fairly minimal disruption to us, although clearly we have put in checks because we do not always buy from larger suppliers and it is more internal management time. We have only had one example in the last few years of when we were trying to assist a business downstream to register and it took a period of six months to get that company registered, when it wanted to recycle phones.

Dr Cheetham: Can I give an example of that. If you take the example of Time Computers, which was one of the biggest computer manufacturers in my region based in Burnley employing 600–800 people, and Tiny Computers based down here in the south, they were some of the biggest computer manufacturers assembling in the UK. They bought very large quantities of chips and hard discs and all the computer components at competitive prices because they are such volume buyers, if they needed 8,000 pieces they would buy 15,000 pieces, so they would have a surplus, but because they get such good discounts and cashbacks and so forth, they always knew that they could sell their excess stock out into the markets. In fact, Time Computers set up a distribution division just to do that and towards the end, because margins in these fields are so low, often 2, 3, 4, 5 per cent margins and these companies are getting 20 per cent discounts, or thereabouts sometimes, and I am sure Vodafone will tell you the figure they get, they can prop up their businesses by selling out computer components that they distribute. Both Time and Tiny, since Customs have started their actions, have gone bust.

Q287 Lord Steinberg: We are really trying to find a way of trying to put some kind of rationale as to how we can stop this missing trader fraud, and as we interview more and more people the situation becomes more and more complex. Do you believe that enough is being done from an investigative point of view when a company applies for products from any of the organisations which you are connected with? Do you look at their trading records, their credit worthiness, their banks? Do you look for a history of any problems in their background and, if so, what can you do if you find something that you just do not feel comfortable with? Can I also ask you, in your experience, whether you have had many problems where genuine traders are practically put out of business because they have claimed the VAT back but, because of Revenue & Customs uncertainty as to which is genuine and which is not, Revenue & Customs are holding up payments in a great many
cases? Finally, what would you do to try and stop this carousel fraud, because this Committee is determined to try and find a way of stopping this fraud which is costing billions and billions—not only in Britain but throughout most of the world?

Mr Howarth: That is a very long question—

Q288 Lord Steinberg: Several, sorry.

Mr Howarth: The first part is generally dealt with within the industry under the heading of due diligence. Now our industry is no different to any other within the UK or within the EU in as much as honest legitimate traders need to establish proper professional relationships with their suppliers; they need to ensure they are knowledgeable in the industry, knowledgeable of the products and run a proper business. Now, at the moment within the UK, whether the traders are legitimate or not, and it is very difficult to discern, the level of due diligence being required by HMRC is almost endless. They seem to have an insatiable appetite for due diligence and no matter how diligent a trader is they are still experiencing extended verification. Now, there are many companies out there, members of the FTI included, who are on the verge of going into liquidation or who have gone into liquidation or are taking professional advice about ways to protect their investments. Many out there have houses which are mortgaged, loans, family loans and business loans, which are now causing them serious problems. We are not just talking about traders who have been trading three or four months but traders who have been trading for 18/20 years. Again, and I have proof of this, these traders similarly have not had the legal certainty of trading within the UK and being able to reclaim any VAT due to them, and this has gone on now for in excess of a year. During that period of time, if you withhold company’s capital for in excess of a year, it is not unreasonable to expect that companies will eventually hit financial hardship, and that is where the majority of companies are now. The majority of companies right now are in a situation where, should the extended verification stop with a negative decision on whatever basis, they will not be able to defend themselves or appeal those decisions, which is a very sorry state of affairs for these companies to have got into. How do you solve carousel fraud? It is a case of working together. HMRC need to establish a relationship with new registrations. Putting them through verification at the registration process for six, nine, 12 months is disruptive; it affects other businesses—not necessarily in our industry, there is a knock-on effect down the line. Proper guidelines should be introduced to ensure that when a new registration application is received it is looked into by a professional who can establish whether or not there is a business plan, whether or not there is an intention to trade. Also, the relationship should continue. Why, when you eventually give them registration, give them three months’ grace before they have to account for the VAT? The VAT should be accounted for on a monthly basis automatically until that company passes a series of tests laid down by HMRC to show they are trading professionally, they are accounting for the VAT, and they are a legitimate business. That relationship between HMRC and the trader then should continue to ensure that the VAT which is being collected for HMRC by the trader is accounted for properly and accurately at all stages. So it is assistance that these traders require and similarly at the other end of the chain on the export side. Instead of coming after the event and criticising due diligence, when a trader will sit down with the Customs officer at an inspection stage and ask certain questions and get zero answers: “Is it OK to trade with this supplier? Do you know of any problems with this supplier?” and there is no answer provided, then you go through extended verification and suddenly they start coming up with questions: “What about this supplier? We know of difficulties”, so there is no exchange of information within the industry and HMRC. The FTI have tried on several occasions to open a dialogue and have failed, with basically very bland cut and paste answers to very valid important questions from our industry.

Ms O’Hara: As a large business obviously we are aware of the extended verification checks and delays in people getting repayments, but they do not affect us directly so my comments would be broadly what we have witnessed, and there do seem to be very significant and unreasonable delays. For example, if we want to trade with somebody in the grey market it will not take us six, nine, twelve months to verify that business, it would be a much shorter period, so it does seem these delays are unreasonably long perhaps due to lack of resources that HMRC is prepared to put to this supplier? and there is no answer provided, then you go through extended verification and suddenly they start coming up with questions: “What about this supplier? We know of difficulties”, so there is no exchange of information within the industry and HMRC. The FTI have tried on several occasions to open a dialogue and have failed, with basically very bland cut and paste answers to very valid important questions from our industry.

Q289 Lord Steinberg: Mr Howarth, you mentioned in response to my long question, for which I apologise, two different categories, one was 17–18 years’ trading and others three or four months’ trading. Now, having been in business all my life, I
would assume that somebody who has been trading for 17 or 18 years has probably got a pretty unblemished career and, therefore, they should not be figuring in the hold-up of repayments, whereas the new traders, which you said of three or four months, surely are the ones that are likely to have the problems attached to them, and they are the ones that HMRC should be concentrating on and raise queries on because, from what we understand, carousel fraud and missing trader fraud, whilst it is not new, it is not 17 or 18 years old.

Mr Howarth: One would think that if one was to apply common sense then your comments are perfectly accurate. However, somebody who has been trading for 17 or 18 years will have had weddings and funerals during that time of trading, will have survived those, will be an experienced weathered veteran of industry, and one would think they would not be caught up in this extended verification. However, although we are assured during every conversation with HMRC that there is a selection process and only companies which get flagged up on their selection process experience extended verification, it is our knowledge that there have been no repayments to any trader in a repayment situation within our industry since March of last year. Some traders have gone further than March of last year. Some will tell you they started in December 2005, some in August, some in March 2005, so they are the stragglers, so some have been experiencing this problem since March 2005 and we are now into March 2007. The majority when the policy kicked in 100 per cent was March 2006, so anybody trading from then onwards has been caught up in extended verification. So whether they are indicators of fraud meter moving slightly I do not know, but they certainly managed to pull everybody up on their selection process.

Q290 Chairman: Dr Cheetham, do you want to add anything?

Dr Cheetham: If I talk about due diligence, first of all, and cite an example which I have seen first hand, 2002 was when this really started from Customs. If you look at their own policy papers, which I have seen many times and I am happy to provide the Committee with a copy of these, there is a classic statement in there. Prior to 2002 what Customs did was they worked closely with the traders and set up special teams in Redhill and Staines to try and police the supply chains and remove the bad people. That was the promise made to the traders at the time. But unfortunately their VAT registration checks and these chain-of-supply checks were not working, so in 2002 you see this tremendous shift in Customs from working with legitimate companies to attacking them. In my day when my company was one of the first to be attacked by Customs, the policy papers we saw said: “We need to tackle the real cause of the problem, the exporters. Denying them their repayment will solve this problem”. That is in Customs’ policy papers. They started on my company and that was called a verification exercise. Then obviously we won in the European Court of Justice and there was a lull in Customs activity. Then came the Kittel decision, which was a Belgian case. What this decision said is that where a company has shown that the company did know, in this case a conspirator, or should have known, then Customs can deny their import tax potentially. Now, this is what Customs are playing with, and the instruction has come out from Customs, there is no doubt about it, that they are going to stop every single repayment in chips and phones. I understand between 800 and 1,200 VAT repayments have been stopped, so they have moved from disruption to destruction and really at the moment it is Armageddon. Customs only way to solve this problem at the moment is to wipe these trade sectors totally out. They do not care about innocent or legitimate. I did a presentation three weeks ago to the board of HMRC on my solutions, and they did not deny it, because their only solution at the moment is to wipe it out. On due diligence, because you ask about that, when joint and several liability was first proposed Customs officers were issued with a 27-page questionnaire. They came out to visit a friend of mine and they asked all questions about what checks he did, barcodes, all these things, 27 pages, and at the end of it he said: “How did I do?” And the officer said: “You are not here to do well. We are here now to find out a weakness in your system because if there is something you are not doing it will stay on your file and that will be used against you should we find missing traders in your chain of supply.” Three days later the officer came back with a supplemental list of questions and my friend said: “Why have you come back? I must have done OK in the first questions”, and this set of questions was about third party information that you could not commercially obtain, and as Fred said, due diligence is an ever moving target; even two weeks ago Customs issued a new list of things that they want. But let’s not forget, in some of these 800 companies that have had their VAT stopped the due diligence is extreme. I have seen a company in the last two weeks which not only did checks beyond what you can imagine but they must have had a full-time person working on this, but they photographed the directors of their suppliers, they photographed the directors’ houses, they had copies of their VAT returns and their VAT ledgers but without the company name on it—it was phenomenal. They have been assessed for having the means to know. What Customs have cited in that assessment is that, firstly, the company has been trading for over 10 years and therefore it must have known, and, secondly, that the due diligence

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checks were so extreme that clearly they were suspicious that there might be missing traders in the chain of supply. So you are damned if you do and damned if you do not.

**Chairman:** I think your point has been well and strongly made. Lord Maclennan?

**Q291 Lord Maclennan of Rogart:** I have understood criticisms of the present method of dealing with the problem of this, and how it impacts adversely on the trades. What I am not so clear about, and this is a rather general question, is what you believe would be the more appropriate route for the authorities to pursue. I noted, Mr Howarth, in your letter to us that you spoke of three other countries in the European Union, Netherlands, Germany and Denmark, having a “more targeted approach of hounding the missing traders and prosecuting them”. What do they do that you think is better than what is done in this country, and have you made any recommendations to the authorities here that those particular steps should be taken?

**Mr Howarth:** I think those countries are using the tools which are available to HMRC but they are making better use of joint and several liability. They are implementing joint and several liability whereas although HMRC have joint and several liability it was challenged, the challenge was not successful and it failed on a majority of points. It was successful on one small point but joint and several liability is there, accepted by the industry but never implemented by HMRC. Joint and several liability tends to target the problem which is at the fraudulent end of the chain as opposed to extended verification, which stops legitimate traders’ funds and theoretically stops the fraudsters from committing the fraud. It does not stop them moving on but there has been no attempt to actually catch the fraudsters. Working closely with the industry, reverse charge are other options. These are tools which specifically stop the fraud; they work against the fraud.

**Q292 Lord Maclennan of Rogart:** But those are not tools being used in the Netherlands, are they?

**Mr Howarth:** It is mainly the extended verification; it is tighter verification of VAT numbers; it is making sure that new companies when they register as traders are vetted properly and consistency and continuously. It is not a case of: You have a VAT number, off you go and start trading. It is a case of: “There is your VAT number, you need to account for that, we will monitor it and we will come back”. So instead of coming back frequently visiting the exporters, HMRC might consider it better to spend their time visiting the rest of the trade, and particularly the new traders, the new people coming on, to ensure they are trading properly and legitimately, and these are the tools being used by the other countries.

**Q293 Lord Maclennan of Rogart:** Have these representations been made by you?

**Mr Howarth:** We have tried to open dialogue with HMRC but they do not wish to sit down and talk about it. We put various questions to them and we have written to them but we do not get responsible answers, and when you find you are bashing your head against a brick wall you tend to stand back and try and find another avenue. We see the only way forward being to legally challenge what they are doing.

**Dr Cheetham:** The problem is that the method that Customs are using at the moment is allowing fraud to happen. The fraudsters, the organised crime, the money is gone. I worked closely with the Panorama programme which you may have viewed, and the Belgian team who were on there say the losses of 2005–06 were £8 billion, not the £3 billion that Customs portrayed. The problem is that what Customs are trying to do is trying to claw the money back from the other end of the chain, from the legitimate companies at the other end, and the money has already gone. The fraud has already occurred. There are two ways of solving this problem. The first is to change the legislation, the second is to try and sort it out in-house. If you sort it out in-house you have to stop the fraud. All of Customs policies have been to try and recover the losses from the legitimate companies. The fraud takes place; they do not care. 100 successful convictions for £8 billion lost is ridiculous. You have to stop the fraud at the outset and not let it occur, which is why the logging system I propose works so well for that. I have studied these subjects for four years because I have been forced to with my litigation with Customs & Excise. The problem is that the fraud takes place and Customs try to recover the losses from legitimate companies, and that cannot go on. Customs’ latest weapon is to close the affected trade sectors down and then they will stop the losses, but you have already seen reports. They are shifting into copper, water—the fraud is still going on.

**Q294 Lord Cobbold:** As you have just said, this is an amazing costly problem to not just this country but all European countries and measures seem to be nibbling at the edges. Can you be a bit more specific? Do you think there is a need for a complete rehash of the whole VAT system?

**Dr Cheetham:** Let’s look at changing the systems first of all. No matter how this fraud is dressed up, it is very simple fraud. Goods are brought in VAT-free from a Member State to the UK, for example, VAT is charged and the VAT is not passed across. Companies can collect hundreds of thousands,
millions of pounds of VAT in a very short period of time, and what you have to do is look at that problem. What I have proposed in my written evidence first is the simplest one, “base rating”. Rather than have goods passing between Member States zero-rated, you choose the lowest rate of all the Member States, which is about 15 per cent at the moment, and countries charge each other 15 per cent. Now in the UK that would limit the scope of the fraud down to 2.5 per cent, the difference between 17.5 per cent and 15 per cent. So why have goods passing between Member States at zero rating? Why not have it at base rating? And it would not take much to change. All you would have to do is change the Sixth Directive wording to remove “zero rating” and replace it with the words “base rating”.

Q295 **Lord Cobbold**: But would they not import from outside the Community altogether?  
**Dr Cheetham**: No, because the VAT is paid direct to Customs when it is brought from outside the EC Community. If you bring goods in from America, as the goods hit the boundary of Europe or the UK you must pay VAT direct to Customs or use a deferment account, so Customs collect the VAT straight away. So this fraud only works in Europe. So you stop the goods moving at zero rate. You either use base rating or you pick a middle rate and I call that median rating.

Q296 **Lord Cobbold**: You cannot use the system applied in the United States?  
**Dr Cheetham**: No. Fraud does not work between the United States; only in Europe. Could you say that again, please?

Q297 **Lord Cobbold**: Could you not apply the system applied in the United States to imports from European countries?  
**Mr Howarth**: That would restrict freedom of trade. Under the Sixth Directive you are not allowed to restrict trade.  
**Dr Cheetham**: Europe has to be a level playing field—that is the whole idea of the Sixth Directive, to create this level playing field. If you had this rate of 15 per cent, or a middle rate—the range of VAT is 15–22 per cent in the Member States so if you picked a middle rate of, say, 18 per cent and everybody selling goods between the Member States just charges 18 per cent between the Member States, that will eliminate the fraud. It is that simple. There will have to be some balancing of the two-way trade between countries because countries will be collecting VAT from other Member States, so there will have to be some balancing depending on the outcome of the trade levels. So the first option is base rating or median rating. A second option obviously is to have a point of destination tax. Now, point of origin tax was something that was considered early on when this transitional system was implemented. What a point of destination tax means is that you charge the VAT rate of that country, so if Germany is going to sell to the UK they will look up on the tables, the UK VAT is 17.5 per cent and they will charge 17.5 per cent. To France, Germany will charge 16 per cent. If you sit in the UK and you look outward now, you see that if you are buying from the UK you are paying 17.5 per cent, and if you are buying from France and Germany you are paying 17.5 per cent, and that creates the level playing field that the Sixth Directive is meant to implement.

Q298 **Lord Kerr of Kinlochard**: Could I, first, ask a technical question, and can I ask it of Ms O’Hara first? I understand that every mobile telephone has an identifying number, an IMEI number. Do Vodafone keep records of all the IMEI numbers of all the telephones that pass through their hands?  
**Ms O’Hara**: Yes, I believe we do keep records.

Q299 **Lord Kerr of Kinlochard**: Dr Cheetham, did your company, the one that was attacked in the way you describe, keep IMEI records of all the telephones?  
**Dr Cheetham**: My company was destroyed in 2002. In that time we had bar code scanners for insurance purposes. Since then it has become the norm, so in my day we only had the records for insurance purposes.

Q300 **Lord Kerr of Kinlochard**: If it was a requirement that anybody trading in mobile telephones kept records of IMEI numbers—  
**Dr Cheetham**: It is a requirement.

Q301 **Lord Kerr of Kinlochard**:—then would that not make the fraud rather difficult? If the same number appeared twice in a company’s books one might conclude that something circular was going on. If it was a requirement to keep the records and, lo and behold a company had not kept records, one might suspect that something fraudulent was going on. Is this not a step that we should take?  
**Dr Cheetham**: First, it is a requirement now. As I said about the ever-extending list of things to do, it is a requirement, but the fraudsters will simply either change the bar codes and forge the bar codes. What happened when Customs alleged that is the mobile phone trade tried to get from Nokia and from Motorola a list of bar codes to verify these were genuine bar codes, and Motorola and Nokia refused to release them.

Q302 **Lord Kerr of Kinlochard**: Let me stop you there. If there are problems like that with a measure of the kind we are talking about, surely it would be a good idea to tackle these problems? In principle, a
Q303 Lord Kerr of Kinlochard: I just wanted to check on the facts. Now, I have heard six different solutions to this problem in the course of this inquiry and one of them, very interestingly, Dr Cheetham has brought out in his written evidence and today. I would just like to check from all three witnesses, please, the six routes that I will try to summarise. I would like to have your judgment, Mr Howarth, of their effectiveness in dealing with missing trader fraud and of the collateral damage or extra cost they would impose on the industry; your judgment against these two parameters. Solution one, what the Government is trying to do, a reverse charge system limited to this sector, with improved co-operation and information exchange, with continental services. The downside of this is the migration of risk into some other commodity. Clearly there is no real problem of interference and extra cost for this sector of the industry but, the solution might not be 100 per cent effective. Secondly, an origin system like the original origin system. Cost of change from destination to origin system right across the board enormous, but mainly a one-off transitional cost, with possibly a continuing cost in terms of the need for a giant clearing-house. Third, Dr Cheetham’s variant on that where you would have a base or medium rate charged. I guess this would, indeed, reduce the incidence of fraud, in this country, but you would be running up against fiscal sovereignty concerns because, de facto, you would, commodity by commodity, be introducing a minimum rate of VAT across the European Union, so quite big issues would be raised. Fourth, another variant which we understand is under consideration in the Commission would be to have a system whereby national fiscal authorities charge the rate of VAT in the country of destination, which would still require a clearing-house system but it would be internal to 27 revenue services. Fifth, there is some form of a technological solution. You, Dr Cheetham, have spoken about a realtime trade logging database. I guess that would have quite a big transitional cost but I do not know very much about it, and I would be interested to hear what you have to say. Lastly, we have, I suppose, a trusted third party solution of some kind. So that seems to me to be the range of solutions and I would like you to consider them against the two criteria, please: effectiveness against fraud and interference with legitimate trade, and the industry. Could I ask for an answer from all three witnesses?

Mr Howarth: Taking reverse charge first, reverse charge removes the fraud from the wholesale trading of the commodity. There is no VAT charged anywhere down the line and when it is exported there is no VAT to reclaim, so the fraud has gone away. The impact on the retail side of the equation is difficult for me to judge, not being involved in retail, but on the surface it would appear that we are moving the burden from the exporter currently to potential retail fraud, so I would say maybe that would be moving the problem from one area to another, although maybe not in such a big way. On the origin system and self-clearing, this is very difficult because these introduce a cross-border taxation system and the very concept of the European Union is freedom of trade. If there are different rates of cross border taxation then the normal entrepreneur will be looking for the sharpest edge, which country to go and trade from, and if I can make an extra 1 or 2 per cent profit by trading from France rather than from the UK then I will go and trade in France. It would be a commercial decision and I would be a fool not to. One would have to discuss those problems with tax experts and economists to see whether or not they are viable and whether or not they in themselves were open to other fraudulent activities which are there. The realtime logging database option goes back to 2003, when almost everybody within the trade was directly sending their trades down to Redhill—in a non technological manner, granted, but the details of the trade from virtually everybody in the chain would be sent down to Redhill. So if somebody was offering a company stock the supplier of the stock would submit that offer down to Redhill with full company details, full details of the trade, where they were buying from, who they were selling to, and they waited for the response. Similarly, by the time it comes up the chain to the exporter, the exporter would submit the trade. On many occasions traders were informed that there was a discrepancy somewhere down the chain. They were always very careful not to reveal how far down the chain or where in the chain the problem was under data protection, but there was a problem. From my experience and my knowledge of the industry, if a trader was advised of that then they would take that advice and would not continue with the trade. That, due to lack of resources on HMRC’s part, was withdrawn in early 2004 and no matter how much information you presented HMRC at Redhill all you would get back was that the VAT number was valid, and we do not see this as an authority to trade disclaimer. The logging database takes that a stage further in as much as it is a technological approach, and I cannot really comment on it in greater detail but on the surface I would say there is a possibility of a timing problem in
that whilst you are still allowing people at one end of the chain to accumulate VAT over a three month period with a further month to account for that and a further month before they realise it has not been accounted for, so the trader at the beginning of the chain has five months to keep the logging database up to date, then you would get the same arguments that Redhill threw at us—today the chain is valid, today the stock is there, today everything seems fine, but in three or four or five months’ time it may have vanished. That is the problem; you are giving the people at the beginning of the supply chains, the fraudsters, the opportunity to manipulate the system for such a long period of time. On the third party trusted with the VAT payments, we examined this about two and a half/three years ago and it could well be that that has come on as a result of this examination. We were trying to look at it from a commercial point of view within the FTI to see about two and a half/three years ago and it could well be that that has come on as a result of this examination. We were trying to look at it from a commercial point of view within the FTI to see whether or not it was a service we could develop and offer to trade and get approval from HMRC to introduce third party trusted facilities whereby the VAT was paid into account A and I traded with the trader in account B, with all the VAT ending up in A and getting paid back and at the end of the day it could not go missing. This was seen as requiring data protection and could not be run commercially by the normal industry; it would have to be a government body that ran it, and there is an awful lot of money involved with the interest, et cetera, and all that came into it. I do not think the solution is limited to these five because I think what we have is an overall problem that is not being dealt with. We are not using joint and several liability; we are not improving our verification process. We are disrupting verification and new registrations with making it harder to get registered. If I was opening a florist today I would try and trade below the threshold because as soon as I see the threshold I have the dilemma of can I keep my florist shop running for another six to twelve to eighteen weeks while HMRC decide if I can get a VAT number, and if they decide at the end of it that I cannot have a VAT number how do I account for my trading in the meantime? So it is a very disruptive approach they are using as opposed to co-operating with industry and with businesses and developing a verification process and a monitoring process to make sure that new registrations, new companies, toe the line and follow the rules, that the rules are laid down and they know where they are going and have certainty that if they carry out their actions in one way this will happen and if they go down another path, that will happen. At the moment there is no legal certainty. We do not know what will happen. If I go out and buy phones today and sell them I do not know if I can claim my VAT, and that is the problem. 

Ms O’Hara: In order to eliminate fraud you do require wholesale changes to the VAT system. Of all of the measures the reverse charge would seem the one that would be the most effective because it reduces VAT completely, but you would have to extend it further than just selected trade on computer chips and phones. Our business and that of all of the other mobile operators is very complicated, so all of this is quite complex particularly if you try and put limitations around a set of rules, for example business customers can walk into our retail stores, so what do you do if they are buying a phone or buying a phone in a contract? Wholesale change of the VAT rules is very complex to adopt, and of all of the solutions the reverse charge, extending it much broader to more business-to-business supplies, would seem to be something that would eliminate the fraud completely. Obviously that is very difficult to achieve, particularly to reach agreement at EU level as well, so I think there should be some more immediate measures, certainly around the joint and several liability and a more targeted approach by Customs, with them using their resources to validate repayments quickly. There should be a domestic short-term measure whilst they look for more long-term measures to tackle this or similar fraud. Concerning the origin system, or the flat-rate system or destination system, I have had various conversations at EU level and certainly any suggestion of an origin system is rebutted. You will never get agreement on a single VAT rate and clearly, if we have different VAT rates, then businesses will want to locate themselves in the lowest rate and supply from that location, which I think is understandable, so harmonisation is not somewhere we will get to realistically. On a flat-rate origin system, again, I think there are quite a lot of complications around that. If you are talking about having a flat rate for cross-border trade then you have a distortion between domestic trade and cross-border trade, and there are a lot of complications within larger businesses. When you drill down to the level of detail these changes would take a significant amount of time, not the eight weeks which it has been suggested Customs would allow for businesses to implement changes. Using a destination system, where you are charging VAT at the destination, again, this needs to be well thought out. Is this just for cross-border trade, or just selected products? My concern there would be I am not sure that some of our billing systems, which are very large lumbering beasts, could accommodate 27 different VAT rates, so the cost of making changes could be astronomical and run into many millions. Added to that, it requires businesses to understand what the standard rates are, what the reduced rates are, what all the different rules are in the different countries, as well as potentially being subject to audit by 27 countries which is quite a large requirement, so I cannot see that we would necessarily favour that. In terms of a realtime logging database I do not have enough information about
that, but anything that has a technology solution can be simple and easy to implement or might be quite costly to tie into our systems, so without a proper interrogation I could not really comment but I do always have some concerns when people talk about technology systems because we have very complex technology for the whole of our system, so it might be easier or it might be something quite costly that would take perhaps 18 months to two years to implement. Using a trusted third party, again, does not feel like it is really addressing the fraud, and it feels like an expensive option. Where we are shipping in vast sums of handsets through our system how much would we reasonably have to pay out to control when the fraud actually takes place far later down the supply chain?

_Q304 Chairman:_ Dr Cheetham, is there anything you want to add to your colleagues’ remarks?

_Dr Cheetham:_ As my Lord Chairman may be aware, the reverse charge was applied for by three Member States at the same time. Germany and Austria wanted it on a very broad spectrum of product with the capacity to expand it on to whatever they felt like; the UK went in with a very narrow request, mainly chips and phones and some other high value IT goods, and the UK succeeded. But what the UK was really doing with reverse charging, and doing it on its own, was saying: We are going to wash our hands of the problem, we are not going to have VAT on these products, and therefore the fraud will continue on with the other Member States. But it creates three new frauds. Firstly, it creates an end-seller fraud, so you will have companies selling, say, on the Internet: they have bought from the supply chain VAT-free; sold on the Internet to the public and collected the VAT and do not pay the VAT across, so it will shift the fraud from one end of the chain to the other and, secondly, it will create end-user fraud where people will pretend to be VAT-registered in order to get fraud. On the self-clearing origin system—it is written and up and running and I demonstrated it to Customs a few weeks ago, and it will eliminate the fraud at the first deal. What happens is you do not pay VAT to anybody in front of you unless they give you a valid invoice with a valid VAT log number on it which is generated from a website or by the telephone. What Customs would have to do is shift their resources which are now used for destroying legitimate companies to policing the system.

_Q305 Lord Kerr of Kinlochard:_ So this would be an IT way of getting back to the 2002 situation that you spoke to us about?

_Dr Cheetham:_ Yes. It is the first deal. Because you do not pay VAT until you get this valid number and the log number goes down the chain and you get a new one at each stage of the chain, then the only way that the fraudster can sell his goods in the UK is to go right at the start of the system on to the Internet, or by telephone, or even by text message, and get a log number—

_Q306 Lord Kerr of Kinlochard:_ Yes, I grasp the concept. What about the last solution, the idea of the trusted third party?

_Dr Cheetham:_ Can I just say something extra which is important about the VAT logging system? Because of the FTI’s case and their success in the European Court of Justice, one of the things the European court said they could do is require a security guarantee. That means you can ask a company to deposit VAT or its equivalent. With my VAT logging system what you do is when the system pops up on Customs computer they go to the company and say: “OK, we require that VAT to be deposited with us—first deal”. Now, missing traders usually have to make a loss and, therefore, they would not be able to deposit that number so you turn off the logging
system and that company can no longer trade. So you run that system, you make them deposit the VAT, and under the security guarantee rules the missing trader will not be able to operate and it will eliminate it. The factoring system is very similar. In my system, because you are using a security guarantee to get the VAT off them, Customs hold the VAT. If you introduce a factoring company they are going to make charges and so on. It is far better that Customs take the VAT live off the missing trader and when they have the VAT they will let them do the next one and so on down the line.

Lord Kerr of Kinlochard: I am very grateful.

Lord Steinberg: Finally, I am sure I and all my colleagues here hate the idea of genuine traders being squeezed to go out of business because they are not getting their VAT refunds, but how many criminal gangs do you estimate are doing these frauds in a sophisticated way, and what do you believe the best way of stopping them is?

Q307 Chairman: I recall a figure of around 15–20.

Mr Howarth: I could not begin to estimate. I have no knowledge whatever.

Dr Cheetham: These people are right at the other end of the chain, so we have no idea. It is Customs job to police the industry, not ours.

Ms O’Hara: I think it is a fair point. We need more targeted measures, specifically at fraudsters, so better exchange of information would be good certainly, and also trying to give legitimate businesses some sort of certainty. When measures were introduced Vodafone said: “We have put together what we think are reasonable checks, can you confirm whether or not you think they are reasonable?” And they said: “No, we are not in a position to know whether or not it is reasonable”. So when a large business does not have that certainty it must be very difficult for small businesses to trade in that environment.

Q308 Chairman: Mr Howarth, could you provide us an update on the FTI’s planned judicial review of HMRC’s actions?

Mr Howarth: Yes, certainly. Back in May 2006 we were getting reports from members and non members within the trade, because we had conversation within the trade in general, that their VAT repayments were being withheld; they were getting various comments from the local HMRC officers, and the normal cycle had been broken. We were not overly concerned at this stage because on a selected approach this had happened back in 2003–04, where selected traders had experienced these difficulties in a very small, minor way. By June 2006 we realised from the number of inquiries we were getting that almost 100 per cent of anyone we had spoken to had not had a repayment since March, so by June March was held up and a lot of them had been told that March had been subjected to extended verification and any work done in April would probably be held up as well, so we realised there was a problem there. Some of the larger companies and one or two of the smaller ones began legal action, and again the FTI was in conversation with these people and advising them and providing information where we could. The JR route is not a straightforward process in any way, shape or form; it is highly complex and very expensive; but several of the cases during October managed to get a hearing date, not for the JR but for an application for interim relief under the JR. It was a way of getting in front of a judge to try and get some of the information. What has happened without exception so far is that every time a JR has appeared before a judge it has not been heard. Now, despite what was said back on 6 February I would say there have been 14 JRs, three of which are still pending, and only just, and the other 11 have all received negative decisions before the JR was heard. So before all of the information and evidence has been gathered, all the witness statements, all the statements of claim which have been assembled over several months for each of these companies gets heard by a judge, plus the judicial review of the activities of the HMRC, they were all stopped. One way or another every one of the JRs that has gone forward has been stopped. The FTI took advice whether or not we could launch an action which could not be stopped because we do not have any trading to have a decision made upon. It is not: “We would like you to stop verifying our claims” that we are asking; it is the legality of what they are doing that we would like reviewing. I said there were still three JRs pending; these three have gone through the initial stages of the paperwork being examined by the judges, who have gone through oral submissions to determine whether or not they will get permission to go forward into what is called a full substantive hearing. There are three companies destined for a full substantive hearing next week in front of three separate judges with three separate legal teams on the trader’s part and three on the part of HMRC. Yesterday, HMRC put forward a motion to have those three JRs set aside, so although they have gone through all this and they are trying to get some judicial control over HMRC’s activities, HMRC’s lawyers are now asking the judge to set those JRs aside on the basis that there is a tribunal hearing in April which might affect those JRs. Now, the tribunal hearing is about a trader who traded in a certain manner and has had his repayment disallowed; the judicial reviews are not about having it disallowed but about HMRC’s activities, but they are trying to move the goalposts again and not have the case heard. So on 6 February, when the question was asked whether HMRC’s activities are legal or are they acting lawfully, it may be ill-advised but the
response that they are not acting illegally is incorrect. The FTI have it on good authority, and we have spent the best part of three months going through the legality of what HMRC are doing and the basis upon which they are doing it. The JR we are bringing forward is well supported from within the industry by traders who quite honestly cannot afford to support us but they are finding means and ways of doing so. The JR says that what HMRC are doing with extended verification is unlawful in that they are rolling up into one a verification process which has legality and case history which says that this is what you can do for this period of time that has been accepted by the High Courts with an investigative process, so they are not just verifying our claims, although they call it verification; they are investigating and withholding the payments from these trading companies until they have finished their investigations and that is what we are saying is unlawful. Similarly the basis upon which they are carrying out this investigation is an error in the law. It is a misinterpretation of the Kittel case. There is Optigen and Bond House and the FTI which quite clearly from the ECJ specify what the “knowledge” is, what the “means of the knowledge” is and where it starts, stops and ends. HMRC have decided to interpret Kittel as saying that it has no start point, it has no end point, if you have knowledge of any sort of fraud within the industry, whether you are involved or not, then you are guilty. So in quick summary that is the case. It is about to be launched and, hopefully, we can move it forward.

Chairman: Thank you, Mr Howarth, Ms O’Hara and Dr Cheetham for giving this Committee the benefit of your very extensive experience in this most complex of issues.
TUESDAY 17 APRIL 2007

Present: Blackwell, L. Kerr of Kinlochard, L.
Cobbold, L. Maclennan of Rogart, L.
Cohen of Pimlico, B (Chairman) Trimble, L.
Jordan, L.

Examination of Witnesses
Witnesses: Mr Mike Eland and Mr Tony Walker, HM Revenue & Customs; and Mr Richard Brown, HM Treasury, examined.

Q309 Chairman: Welcome to you and thank you very much for coming. I have a slight feeling of Groundhog Day since almost the last faces I saw before I went away for two months were those of HM Revenue and Customs, but it is very good of you to come back because this is a difficult inquiry and there are questions we wish to revisit as well as new questions which have occurred to us as we went on. We sent you some questions ahead of time, thank you for your message, and we all have Annex A of your letter of 27 February before us. We have of course very slightly changed the questions and I am afraid we have decided not to ask about HMRC’s cash flow because it is not particularly germane to the inquiry, but we do now wish to ask a new question on the issue of how this fraud is going to migrate or your views on the possibility of the fraud migrating and where to, for which I am afraid you may be unprepared, but we hope you can do your best with that.
Mr Eland: Yes, of course.

Q310 Chairman: We have also eliminated much of the bit where we ask you whether you have got the sense God gave you to join SOCA, so we will actually not ask that; we think your answer must be obvious. Against that background, we also recognise that you may not be able to produce answers to everything if it is getting in the way of your ongoing operations, but actually I do not believe our questions are of that nature. I will start please with the first question: have you been able to estimate the costs to business in the relevant sectors of introducing the reverse charge mechanism which will come in in June 2007?
Mr Eland: We are currently working with the industry on preparing a proper, full regulatory impact assessment which will give those costs and we intend to publish that alongside the one remaining bit of legislation that is necessary. It is secondary legislation which will be published early next month, so Parliament, before it finally decides on the reverse charge, will have that information available.

Q311 Chairman: Providing you assume them to be honest?
Mr Eland: Yes, obviously that is right, but we hope that the reverse charge will actually, because it effectively makes the fraud impossible, clear out fraudulent operators from the system.

Q312 Chairman: Yes, I see, so there just will not be any of those left.
Mr Eland: There is no benefit to them in continuing to trade.

Q313 Chairman: You are presumably going to be using quite a lot of resources on assistance to trade?
Mr Eland: Yes.

Q314 Chairman: Presumably you have taken those resources from somewhere?
Mr Eland: There are several hundred staff that are, we call them, ‘the targeted education group’ where their regular day job is to help taxpayers with new legislation or new businesses coming into the system. They are a dedicated group that have a turnover of that type of work, so we will not be diverting any resource away from the verification campaign in order to carry out that activity, but it will be a separate block of existing resource.

Q315 Chairman: Are you offering businesses help and support as they prepare for change?
Mr Eland: Yes, we are. We have had a number of discussions with them in actually designing the reverse charge to help shape it in a way that minimises administrative costs. We have also held a series of workshops and so on to answer questions, give guidance to some of the trade representatives. When the reverse charge is actually introduced, we have a dedicated resource that is aimed at educational support to taxpayers who are dealing with any change to the tax system and part of their programme for next year will be helping people who are dealing with the reverse charge, so we will be offering that range of support and obviously guidance and so on as well. We have also said in the publicity that we have been putting out around the reverse charge that we will adopt a light touch towards compliance activity in the first year of the reverse charge, so we will not be going round looking for people who have made mistakes and trying to impose penalties and that sort of thing, but we will be trying to help them get it right.
Q316 Chairman: A separate body of people?
Mr Eland: Yes.

Q317 Chairman: So the 1,500-plus you have engaged in various bits of verification will still be deployed?
Mr Eland: That will continue until that exercise is completed.

Chairman: I am not going to ask the question about migration of fraud because Lord Kerr is going to take that one later.

Q318 Lord Kerr of Kinlochard: Could I ask a question about the derogation and about Ed Balls’ written answer reporting on the successful achievement of the derogation? Reading his answer, he said that in discussion some changes were made: the derogation will be for two years rather than the three that were originally sought, but presumably it is renewable; the scope will be restricted to mobile phones and computer chips; the de minimis level will be raised; and some changes to VAT accounting rules would not be made. How do you assess that compared to what you wanted? Is it 60 per cent, 70 per cent, 80 per cent or 90 per cent as effective as what you wanted?
Mr Eland: I think it is largely in the 90 per cent range of what we wanted. Clearly we accept that it is going to need a review in two years’ time and some of the changes in the levels of everything we are content with. I do not know if you want to add anything, Richard.
Mr Brown: No, that is fine.

Q319 Lord Blackwell: I just wondered how clear you think the definitions of these will be to the trades involved to the extent that a phone is a camera is an email machine and a computer chip may be a chip which has other functions on it. Will it be very clear to people what is in and what is outside?
Mr Eland: We have been having discussions now with the industry since January last year when this was first mooted and I think we have gone through some of those types of questions with them, so my understanding is that we do have a fairly clear idea and a common understanding. I think in any tax system that relies on definitions and so on, you are always going to get clearly some potential things at the margins and we would clarify those in the course of the first year of operation, I would hope. As I say, we have made it quite clear that for the first year of operation we intend to operate a light touch and try and help people get it right rather than zoom in on an error, saying, “You’ve got it wrong and we are going to impose a penalty”.

Q320 Lord Maclennan of Rogart: I wonder if you could explain why it is thought that the position requires the United Kingdom to have a derogation and why other countries would be perceiving this as a British problem. Is this simply not going to transfer the problem to other countries potentially?

Mr Eland: We do not think it is something that will automatically transfer the problem to other countries. A number of other countries have expressed interest in fact in having a similar reverse charge. We have had a particular problem in this sector, we feel this is a proportionate and sensible response to it and we have convinced other Member States that it is right and proper that we should go ahead and do it. If I look back to similar problems we had in the gold bullion industry, I think it was in the 1980s, a reverse charge was introduced there which I think now is a standard part of the VAT rules of the European Union, so it is always possible if this is seen to work effectively in the UK, as we hope it will, that other countries will look to follow suit or indeed that the Commission might decide to take it up as a proposal, so I do not think we are exporting the problem.

Chairman: In any case, we will want to ask further about this when Lord Kerr asks about the general question of migration.

Q321 Lord Cobbold: All of us have had letters from British companies that have suffered from delay in VAT repayments lasting up to a year, which in one case bankrupted the company. Why does verification take so long? Why should it last for a year or more, that whole process?
Mr Eland: The verification activity is essentially looking to see whether the companies involved in fraud ignored signs that they were becoming involved in fraud. That is quite a stiff test to establish. It is also an extremely complex area of activity where the fraud is structured in such a way as to deliberately try and conceal further fraud from our activity. In one of these investigations, over 600 companies have been involved in a set of complex, interrelated transactions, so it is a major piece of investigative work that has to be undertaken. What we do do, because obviously we are concerned to ensure that we do not damage the innocent, is we review periodically at various stages in the process whether we have sufficient evidence and reason for suspicion to continue with the investigation, and we believe we have in all the cases that we still have under the process.

Q322 Lord Cobbold: Do you think you have caused bankruptcy for innocent traders?
Mr Eland: We have put in place a process so that people who say they are facing hardship in terms of not getting repayments back can come and talk to us about that. We are prepared to make repayments if security or a bank guarantee is offered and we also make repayments of any parts of the transaction that we feel are clearly not linked to any fraud, so business overheads and things like that we have repaid and on any non-associated transactions. Throughout we have tried to maintain the right balance, but we do have to protect the public revenue against what was a major attack on the system in the early part of last year.
Q323 Lord Cobbold: This particular businessman says he approached Revenue and Customs and never had a response from them.
Mr Eland: Well, I cannot, I think, comment on an individual case, but we have publicised this. We write regularly to all the traders who are involved in this campaign, telling them how the investigation is progressing and we have made it clear to people, that we have a central contact point that has been made available. If anybody is dissatisfied with the way we handle these cases, they have not only access to judicial remedies, they also have access to our independent adjudicator and they can complain to their Member of Parliament and so on. We do try to give people avenues if they are dissatisfied with the way we have handled any individual case.

Q324 Lord Cobbold: Do you think there is scope for improving the flow of information by electronic means, as I think there is in the building trade already and we are all familiar with credit card possibilities? Is there any way to make the process more acceptable to business?
Mr Eland: Yes, and I know this is a specific question that you asked in relation to the construction industry scheme. We have set up a facility that enables people to ring and make enquiries about VAT-registered businesses, so there is a sort of mainstream service which anybody can ring up, any registered trader can ring up and check a registration number. For those who are operating in these high-risk sectors, we have, in addition to that general service, added a special service where they can go a bit further than just checking whether the VAT registration number is relevant and also go on to look at whether or not there are details that they have been given about the individual and whether they match with details we have been given. We are looking to introduce electronic checking into the registration process so that we can carry out the registration checks in a faster way and cut down on the time it takes for people to get a registration number, so where we can, yes, we do want to provide a service and use electronic means to develop it and deliver it more effectively.

Q325 Lord Maclennan of Rogart: I was going to raise a question about the legislation on joint and several liability prior to the Chancellor’s announcement that the HMRC had the power to make one trader jointly and severally liable for another’s fraudulent tax, and what I wanted to ask was whether you could give us some indication of the impact of that legislation as it has operated both in respect of the number of cases and the value of the claims that have been withheld, and then perhaps you could go on to indicate the reasons for the announcement in the Budget of the changes to take place on 1 May to extend the operation of the law.
Mr Eland: Yes, in terms of the joint and several liability legislation as it operates now, we have predominantly found it useful as a deterrent and as a means of offering a warning. We have issued around, I think it is, 1,000 warning letters to people where we feel there is an increased risk and that they are in danger of being made jointly and severally liable, and that has actually, we feel, mostly been sufficient. We have actually had to go on beyond that and impose the joint and several liability in relatively few cases.

Q326 Lord Maclennan of Rogart: Can you say how that warning works and what you think the consequences of it are?
Mr Walker: When certain facts have been established, it is a letter that we would write to the VAT-registered business, indicating that there had been tax losses in the transaction chain and effectively warning them to take more care in future and, should they not take sufficient care, they may be jointly and severally liable on the tax due on future transactions.

Q327 Lord Maclennan of Rogart: This is related to the particular trader who receives the warning letter that there has been some evidence of misfeasance?
Mr Walker: In the transaction chain.

Q328 Lord Maclennan of Rogart: In that particular transaction chain?
Mr Walker: Yes.

Q329 Lord Maclennan of Rogart: But not such as to warrant intervention legally?
Mr Walker: Well, the intervention is to give a warning on that occasion that if that sort of activity continued, then that is when we would consider applying the joint and several liability legislation.

Q330 Lord Maclennan of Rogart: But it is either illegal or not, what has been going on before. Are you saying it might be illegal, you do not know, or what are you saying?
Mr Walker: It is part of the administrative procedure to implement the joint and several liability legislation. As part of that process, we undertook to provide a warning in the first place, so, strictly speaking as far as the law is concerned, we could have applied it on that occasion, but, as a matter of administrative practice, we undertook to Parliament actually to offer up the warning letter in the first instance, so the legal position is that the business would still, strictly speaking, be jointly and severally liable, but we are offering that warning in the first instance.
Mr Eland: That does not stop us obviously from pursuing people in other parts of the chain, some of whom we might have other evidence against and can take action there.
Q331 **Lord Maclean of Rogart:** So you have not actually withheld claims under this, it is in terrorem?  
**Mr Eland:** We have gone on in a small number of cases to further stages, but we have found that the impact of this warning letter has been sufficient in the vast majority of cases.

Q332 **Lord Maclean of Rogart:** To do what?  
**Mr Eland:** To stop them trading in dubious transaction chains.

Q333 **Lord Maclean of Rogart:** So you have really just choked off the business at that point with that warning letter?  
**Mr Eland:** Well, we have choked off the illegitimate business, yes.

Q334 **Lord Kerr of Kinlochard:** My question follows exactly on from what Mr Eland has just been saying in answer to Lord Maclean. I am struck as this inquiry has gone on by the evidence that you have been very successful in stopping the fraud in computer chips and mobile phones. But the evidence also suggests that you have done that by closing down large sections of the trade, and that “extended verification” means that the papers rest with you for quite a long time, while no payments are made. You mentioned access to judicial remedies, but we have seen some evidence that the authorities have been opposing hearings in cases brought by some of those affected, and you might want to comment on that. But it seems to me that our congratulations to you on achieving the reverse charge derogation, which presumably solves the problem in relation to these two commodities, have to be tempered by our growing feeling that this success will be followed by the migration of the problem to other sectors. In her letter of 27 March, the Paymaster General suggests possible migration to textiles, razor blades, golfing equipment, pharmaceuticals, soft drinks as well as the hot favourites, iPods and SatNav systems. I guess that by order, so again we have got another weapon to use that”. We are also introducing in that Bill the power to vary some of the joint and several liability legislation in place so that we can detect patterns of unusual trading at a much earlier stage and that will be our first line of defence there. I do not want to be complacent about our ability to track that. We are dealing with extremely resourceful people here and, therefore, I will not rule out that we might also see an extension of the reverse charge. Equally, the joint and several liability legislation, the reason why we are extending that in the Finance Bill, and I am sorry, Lord Maclean, I did not answer that part of your question, is because we are looking ahead and saying, “Well, might there be a move into some of these fringe activities, like iPods and so on? If so, let’s have that joint and several liability legislation in place so that we can use that”. We are also introducing in that Bill the power to vary some of the joint and several liability legislation by order, so again we have got another weapon to enable us to be able to do things if this fraud starts to emerge in other areas, so we will need to be very vigilant. We might need new legislative means and so on to tackle it, but I feel that we are in a different situation with a move into new sectors than we were in, seeing it become very well established before we were really on to it in these two earlier sectors.

Q335 **Lord Kerr of Kinlochard:** I was going to ask why, but in the light of your answer I would say when, but if you begin to suspect that it is migrating into another sector, will you, in addition to the things you have...
described, be applying the “extended verification” technique which you have been using up to now?

Mr Eland: That might well be part of it, yes. Would you like me to go on to explain the extent of the verification process and the risk process?

Q336 Lord Kerr of Kinlochard: To us, it looks a bit like a blunt instrument.

Mr Eland: Well, I do not accept that it is, and I think that it is important that I do explain that to the Committee and if I may I will do so in response to this question. Perhaps I could just give a little background. To make this fraud operate, you need three groups of people. You need the organisers, a relatively small number of people, and we will be coming on to who they are and so on later. You need the missing traders who are usually men of straw and the whole purpose of them is to have no assets, and then you have got a whole raft of people in the middle without whom this fraud cannot work. They have to have a degree of knowledge of what is happening, otherwise you cannot keep a carousel moving. To make a carousel move, people have to sell to the right people and they have to sell at the right price, so it is not just a set of haphazard transactions which somehow seem to manage to keep going round in the same circle, but it clearly needs an element of contrivance there, so it is that middle group of people that we are looking at in the verification process. Those groups are not the whole industry. We think that the reverse charge will affect something like 15,000 companies. The number of people whose repayments we are investigating in this verification campaign, and I do not want to get into the precise details, but it is a very small part of that 15,000 and in percentage terms it is in single figures, so it is not the entire industry, as some of the people giving evidence before you have, I think, suggested.1 How have we selected those people? Well, we have done so by looking at things like patterns of trading, but we have also done so in relation to particular flows of trade. I did ask the Clerk to make sure you all had copies of the letter of 27 February from the Paymaster General and annex A to that letter which shows a table which gives figures produced by the Office of National Statistics of the value of trade in these sectors over a time period. If you look at those, you will see that in 2004, a typical quarter was something like £0.6 billion in trade and that then gradually grows through December 2005 and in the first two quarters of 2006 that jumps to £11 billion and £14 billion. Now, there is, I think, no way that we feel that that trade is any sudden new grey market which has appeared. We have talked to members of the big four accountancy firms, we have talked to mobile phone manufacturers and so on, and we have found no commercial explanation for that dramatic jump, nearly tenfold, and it is that period of repayment claims made in relation to that volume of trading with this select number of people that we are investigating. We are not doing so in order to delay the repayment; we are investigating whether it should be made at all. Where we feel we have evidence and that the company involved either knew or should have known because of the way in which they were asked to construct their commercial supplies, then we feel under the legislation that we are entitled, indeed obliged, to refuse that repayment. Therefore, I would characterise this not as a sledgehammer, but as a targeted investigation of attempted fraud on the system. Now, I am not accusing everybody in that chain of being a fully complicit party to the fraud, there is a variety of different degrees of evidence here, but what we are doing is looking very carefully at all of the transactions, at the relative prices and so on that they give to test whether or not those are genuine commercial transactions or actually cover for this fraud. That is the purpose of it and I do not think we are being disproportionate and I do not think it is a sledgehammer.

Q337 Lord Kerr of Kinlochard: Thank you very much, that was an extremely helpful answer and it clarifies a lot of things. The doubt that is left in my mind is that, whilst we would all wish you to succeed in stamping out fraud, and nobody is suggesting that it is not right to act firmly against fraud, you may be asking traders to prove a negative, to prove that they did not know or that they could not have been expected to know that somebody else in the circle was a fraudster. That is inherently difficult to do. I am now talking of the legitimate trader caught up because one of your traffic lights has gone to amber, he needs to prove a negative to get his money and you are not required to prove a positive, and you sit on his payment. Is that unfair?

Mr Eland: No, I think we are required to prove either that they did know about the fraud or that they should have known. We have not any case law, I think, on ‘should have known’.

Mr Walker: Not specific cases, no.

Mr Eland: But I think it is more than the negative. As I say, I think what a lot of our questioning is around is whether or not these are genuine commercial transactions and it is very rare, I think, in commercial trading practice where you get a pattern where the margins are exactly the same, no matter whether the volume fluctuates, where suddenly people appear out

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1 *Note by witnesses:* I would like to expand on what we mean by the 15,000 companies. HMRC’s administrative VAT data shows that there are around 15,000 VAT registrations within trade sectors most likely to be affected by reverse charge eg mobile phones, computer chips etc. This does not mean that all of these 15,000 companies will have to change their accounting procedures on introduction of the reverse charge; in fact, the great majority will not have to do so as their sales will come below the threshold of £5,000 or relate to mobile phones supplied with an airtime contract.
of nowhere and are able to supply millions of pounds worth of mobile phones. We are asking those questions, “What action did you take?”, “Why did you enter into these transactions?”, so I do not think we are asking them to prove a negative.

Q338 Lord Blackwell: While we are on this table you have provided us with, Mr Eland, you said that your intelligence will enable you to see where migration is taking place and that that will help prevent this, but it is clear from this table that you were aware of counts of fraud on phones and chips back in 2005 and yet there was that huge peak in the middle of 2006. It is not clear to me, the fact that you know in general terms that people may be switching into iPods or cameras or whatever it is without applying the same verification process, what it is you would do that would prevent it.

Mr Eland: Can I just comment on why we think there was that surge in that quarter which is that in January of that year there was the Bond House judgment which ruled that our previous strategy, which was keeping the fraud down, was not valid in law and, therefore, there was this explosion of activity immediately following that. Fortunately, that case did also provide this new approach, that the repayment could be denied if we could prove this ‘knew or should have known’ test and, therefore, we have put in place immediately we saw those surges, this detailed investigation of repayment claims relating to those periods.

Q339 Lord Blackwell: So, in practice, if you now knew that the new thing was going to be product X, you would direct your army of people looking at this to scrutinise transactions going on in that, or how would it work?

Mr Eland: No, if you are an established supplier of razor blades or something, if this is the worry of the Committee, we are not suddenly going to say, “Oh, we think that there is a slight surge in trading in that area and, therefore, we are going to investigate every single trader there”, and I think that was your worry, Lord Kerr. We would not respond in that way. We would be looking more at the new activity that had emerged there, concentrating our investigation efforts on that.

Lord Kerr of Kinlochard: So we can carry on shaving!

Q340 Lord Cobbold: What about migration to other European countries?

Mr Eland: We work with other countries to look for movements across different boundaries. We hosted a conference of all European investigators and associates recently to share experiences and practice and look at how we could co-operate to deal with that and we have mounted some joint operations. Last year we participated in an operation which involved four other countries and hopefully the people we caught as a result of that operation will be convicted, so it is an international problem and it does need to be dealt with internationally, and we are working to do that.

Q341 Lord Jordan: Mr Eland and your colleagues, as you know, it has been suggested to us that the majority of this fraud is undertaken by criminal gangs.

Mr Eland: Yes.

Q342 Lord Jordan: I was interested when you were saying that you have had this international conference. Is there now sufficient collective evidence that it is being organised by established gangs who have migrated to what they see as a soft target and have you any idea of the numbers of people involved in this criminal activity? On the last point where you just mentioned cases, are there any actual or pending prosecutions and have you recovered any of the vast amounts that this fraud has enabled people to take?

Mr Eland: In terms of evidence, I do not want to get into too much detail, but I will try and give you a picture. As I said in my description of the three groups, there is a group of organising gangs who manipulate the chains, relatively few in number—

Q343 Lord Jordan: Established gangs or are they newcomers to the game?

Mr Eland: Some of them have criminal convictions in other areas, some of them do deal in other criminal activity, particularly money-laundering, and there is some evidence of drug-smuggling as well, so yes, these are not purely set up for this fraud, it is people moving out of other areas of criminality into this. There are other people who have become effectively an organised group that have specialised in this, so it is not all one type. Finally, some established criminal gangs are now, as is normal in the criminal world, extracting extortion from the organisers, so some of the big London crime family types are actually saying, “We want a percentage of your profit”, so it is very much into criminality and, therefore, we do work closely with the Serious Organised Crime Agency and we also work closely with a number of other police forces, with the Metropolitan Police, Manchester Police and Staffordshire Police and a number of others, in looking at this in the round. I think that answers part of—

Q344 Lord Jordan: Are hundreds or thousands involved?

Mr Eland: It is a small group. It is in the hundreds rather than the thousands, the low end of the hundreds. There are not huge numbers of people, but they are serious criminals.
Q345 Lord Jordan: Are any of them currently facing charges and have you recovered anything from them?
Mr Eland: Last year we had two major operations, one of which involved 400 of our own investigators and 100 police, and we believe that the people in that operation were one of the organisers, but it has obviously not come to court yet, so I cannot give you any further details than that, but we arrested a large number of people and we hope to bring that in a major prosecution. In terms of the assets, I cannot give you the numbers off the top of my head, but it is a part of tackling the fraud which we do take very seriously. We were involved with the Dutch over the Bank of Curacao, which was a bank which was being used for moving the proceeds of this fraud, and we have a number of freezing orders in place on accounts in that bank, so it is something we do take very seriously and go after.

Q346 Lord Jordan: The derogation, as you were saying, is obviously going to be a tremendous help. It has been suggested that this crime could even go into very high-value products, not large numbers, but very high-value products. Do you really feel that you have got sufficient powers to investigate the potential breadth of this fraud and the way in which it almost interplays with other groups? There are freight-forwarders, for example, who might be facilitating a crime, although they are themselves acting within the law. Do you have enough powers or are you seeking any more?
Mr Eland: Other than the ones we are seeking currently in the Finance Bill, which I touched on earlier, we do feel we currently have the right range of powers. Because the fraud does potentially migrate to anything, it might be that we need to come back to Parliament in the future looking for additional powers, but at present we feel we do have those powers. One of the ways in which we have approached this fraud is to try and use the full range of our activity. You mentioned freight-forwarders and we do have our Customs staff who are involved actually in checking the consignments and things as they go round, scanning the numbers on mobile phones into a computer database so that we can now start to actually see the rotation of carousels, and obviously that is now acting as a brake on people doing it. In the case of exports and freight-forwarders, we have come across, as part of this extended verification campaign, a number of incidents now where goods have not been exported when they are claimed to have been exported or they have been mis-described or false values have been given. There is a whole range of things like that where we can bring some of the Customs legislation into play against that, so we are trying to use the full range of powers.

Q347 Lord Jordan: Have you any specific areas of worry yourself that you are thinking about? You have tried to cover everything, but are there some you are thinking of?
Mr Eland: None that I particularly want to highlight to the Committee, but I do not want to give the impression of saying that I think we have got enough powers and no, I do not have any worries or that I am at all complacent. I do have a lot of worries obviously with such a large-scale fraud that we do tackle it responsibly and well without damaging legitimate business where we can avoid that, so I am not at all complacent on that, but I do not think we have anything missing at the moment. Ministers have been very ready to legislate to help us in this and we have had legislation in the last two or three Finance Bills and I think that is keeping pace with what we need.
Chairman: We would now like to change our focus a bit to, instead of grilling you about what you are doing, what could be done differently.

Q348 Lord Blackwell: Listening to you, I think we are all very sympathetic to the challenge you have got, but it does, perhaps unfairly, feel a bit like putting fingers in a dyke and lots of fingers as new holes spring, and even though reverse charging is in a sense only a temporary derogation for two years, because of the way definitions move it would be difficult to imagine something which had relevance perhaps beyond that, and if someone had a derogation for gramophone players years back, how relevant would it be today? I think I am left with the feeling that you are doing your best to deal with an issue that is a problem of the way the system is designed and works, but there is still an underlying problem in the way the whole system is set up. If you think about what you could do, one solution is just to accept that it is a function of the system and that there will continue to be fraud of this scale and it may migrate and you will run as fast as you can to keep a lid on it, but there will be continual sore, a continual loss. The second solution would be to say, “Can we change the VAT system to eradicate some of the loopholes?” but it seems, and I would be interested in your comments on this, that most of the things one could do to change it may end up imposing more uniformity or more centralised control over the system, so you run into the issue of whether that is acceptable and whether it is uniform rates or a centralised clearing house, but have you thought about any of those and are there any of them which would work? The third solution is actually the problem with VAT and whether we should extend the principle of reverse charging to its logical conclusion and actually go back to having a sales tax.
Mr Eland: I am going to ask Richard Brown from the Treasury to come in on future systems. All I would like to say, speaking from an operational perspective...
if I may, is that yes, it is always the best solution to change the rules so that things cannot happen in the first place. Any enforcement activity is always going to be following on after the event or in response to a failure, if you like, of those rules, so getting the rules right, I agree, is obviously what we want to do. That is often easier said than done. I will now hand over to my colleague from the Treasury to talk about that.

Mr Brown: Given that we are where we are, having the targeted reverse charge and the derogation agreed is going to be a major weapon in our armoury as far as the fight against VAT fraud and in particular MTIC fraud is concerned, but we are more than prepared to explore all options that will allow us to assist in combating VAT fraud. I think though that we have to assess the possible options against probably three criteria. The first is to ensure that the right tax ends up in the right place, that is, the Member State of consumption, at its rate and that is something which avoids the harmonisation.

Secondly, the new system that you put in place has got to minimise the potential for significant new forms of fraud and non-compliance, and the third point, again, I think the point you mentioned, is that we have to avoid putting unreasonable burdens on business, and I think Mike Eland would probably add “and tax administrations” in the new system that we might put in place. It might be helpful to take those criteria and talk briefly about what would happen if you got rid of the zero rating of intra-Community supplies. I can envisage systems where you would get the right tax paid in the right place, and actually technology has moved on so that you could probably do it on the basis of specific transactions and you would not need the sort of clearing house operated on the basis of macro-economic data which was discussed extensively in the early nineties. In that sense I think the potential of new technology means that one can look at other solutions that were not available then. However, there would be, I think, in almost all of the alternative regimes to the one that we have in place at the moment, new non-compliance and fraud risks. For example, could a Member State be certain that it would receive the tax due from transactions involving a business based in another Member State and the tax which the Member State and its business would seek to recover, so that in place of the current arrangements where the tax zeroes off you have both a payment and a claim associated with it? Ensuring compliance across borders, which is what could happen, is a very difficult thing to do and the amounts of money that are involved are potentially huge. There would be around £40 billion worth of VAT associated with goods coming into and going out of the United Kingdom. To ensure that you are not suffering very significant tax losses the level of compliance that you would then need to have would have to be extremely high, and if you were to ask me whether we could be confident that we are in a position where the compliance losses would not be significant I think I would at present have to answer in the negative.

Lord Blackwell: Could you just elaborate on that point? If you get rid of the zero rate and then suppose anything coming in came in with the originating country having a rate of 15 per cent, say, so it comes in having had tax paid, and on everything going out we collect 15 per cent, where is the compliance risk there? Once it has come in somebody has already collected the tax. We have not got to refund stuff across the border. If it has gone out it will go out with export records. It will cross a border somewhere where you can check that the 15 per cent has been paid going out. I understand the numbers may add up to a different amount than the current system.

Q349 Chairman: This is beginning to look to a lay eye like one of the more sensible systems that one might consider, a flat 15 per cent tax which takes the fun out of the fraud fundamentally. We do need to press you on why that will not work.

Mr Brown: I understand. I do not think that I have said that it would necessarily not work. What I have said is that there would be considerable risks associated with such a system and that the difficulty that arises is that, for example, if you had the situation where a business in one Member State failed to pay the tax due whilst in the other Member State you have got the tax being claimed, how would you ensure that you had not got one or other tax authority out of pocket and which tax authority should it be? These are not problems that arise when you have merely got transactions taking place within a Member State.

Q350 Lord Kerr of Kinlochard: Mr Brown, I think you are repeating yourself. I think this is exactly what you said when you came to see us in February. I do not think you totally convinced us then that the risks of being defrauded by other people’s fiscal authorities, governmental services in other Member States, were as high as the present risk of being defrauded by fraudster traders. We do see some possible attraction in the areas which Commissioner Kovacs is talking about, and we do not accept that there is a £40 billion risk of being defrauded by other Customs revenue services across the European Union. It seems to us that that risk must be lower than the risks you run now from having goods crossing frontiers with no tax paid, leaving you chasing the fraudsters by all these subtle methods you have been describing to us. In principle I do not think we really buy your £40 billion.
Mr Brown: I think that in forming a judgment about the point you have put across you have to have a view about the level at which we can reduce fraud and losses under the existing regime and the combination of the reverse charge to get rid of the problem with phones and chips plus the operational strategy applied by HMRC to reduce the level much below the levels that we have had before and that have led to the very large degree of public interest in VAT fraud that exists at the moment. The other side of the equation is the risks associated with collecting the tax from other administrations or being confident that other administrations are going to be, frankly, as interested in collecting tax that is going to end up in the United Kingdom or some other Member State as they are in collecting tax that is due in their own.

Q351 Lord Kerr of Kinlochard: It is not necessarily tax that is going across the frontier. Commissioner Kovacs is talking about a different solution, as you know, whereby everybody pays 15 per cent on intra-EU exports. You do not get the money collected elsewhere. You get the money when a British exporter exports. That seems to be the idea. He is interested in 15 per cent which is not transferable from one country to another but is retained by the country where the consumption takes place.

Mr Brown: But that is an origin system.

Chairman: Yes, a flat rate origin system.

Q352 Lord Kerr of Kinlochard: So?

Mr Brown: But the result is that the tax is not ending up in the Member State where the consumption takes place.

Q353 Lord Kerr of Kinlochard: But it is open to the government of the country where the consumption takes place to charge some more. Its rate could be higher. Yes, it is a modified origin system that Commissioner Kovacs appears to be talking about. That is why we are pushing you a bit. We do not really buy your argument that you cannot trust other revenue services to do their job. We think they are on the whole likely to be more trustworthy than crooks; but we want to know what lies behind your use of such arguments.

Mr Brown: Given that you are talking about an origin system, there is a panoply of things that goes with it. For example, what do you do about reduced rates in such circumstances, a politically sensitive issue both for us and for other Member States? I do not think that the ideas that Commissioner Kovacs has advanced really address that sort of question and they end up with money being in the wrong place. If you are a net exporting economy you would show a gain from such a situation. If you are an importing economy you would see a revenue loss, and that has not been acceptable in the past and I am quite surprised that—

Q354 Lord Kerr of Kinlochard: Let us come back to reduced rates for a second. Take, for example, zero rating on children’s clothes. The UK price of children’s clothes manufactured elsewhere in the European Union would go up marginally if tax had been paid on their export from that other country to us. The price of children’s clothes manufactured in this country or manufactured in China would not change at all. We would still apply our zero rating. So there would be a marginal increase in the cost of that part of the market occupied by children’s clothes produced elsewhere in the EU. That is all. I do not see why that amounts to an argument of principle against what Commissioner Kovacs is talking about. I do not see why our right to zero rate sales in the shops of children’s shoes and clothes would be affected at all by what Commissioner Kovacs is talking about.

Mr Brown: The fundamental point is that the right tax would not end up in the right country and you could have winners and losers to the extent of billions of pounds as a consequence.

Lord Kerr of Kinlochard: That is true. That is usually true in life. I am with Lord Blackwell. I see you rushing around thinking of extremely clever ways to stop the water coming through the dyke and it seems to me the chances are that the water is going to find new holes in the dyke, and therefore I think we need to think about draining the lake.

Lord Trimble: At the risk of being naïve on these matters, not just with regard to VAT on zero rating but with regard to all taxes, is it not hugely desirable as a matter of principle to minimise the disparities of tax rates between trading partners? I am not going to go into harmonisation; I am just talking of it as a matter of prudence, that once you let rates of anything get to a significant disparity between ourselves and anyone proximate to us you are creating a situation where fraud and criminality will flourish and that there ought therefore to be a general consideration, and it is largely in the same territory that Lord Kerr has been raising, that that ought to be the case.

Q355 Chairman: I was reading all the inquiry papers last week and this system was not intended to be permanent; it was intended to be a temporary system. What happened? Why did we collectively never manage to achieve something that does not let water through every single hole, because if you have two different tax rates, a vast difference in tax rates anywhere, of course you get arbitrage, do you not, whether through fraud or illegitimate activity?
Mr Brown: I think what happened was that Member States looked carefully at the alternatives and have so far come to a conclusion that they are less attractive than the transitional regime that we have at the present.

Q356 Chairman: Which is where you started. You said that, as it were. Customs were doing so well in reducing the level of fraud that we should in fact go on trusting them to do that rather than changing the system. It does not seem like a great conclusion.

Mr Brown: I think the pluses and minuses are such that at the moment ministers would not want to contemplate moving away from the current regime. It is perhaps worth mentioning though that there are discussions under way within the European Union which will lead to limited introduction of taxation on cross-border supplies specifically as a response to the development of new technology and e-commerce, that is, the supplies of telecoms and broadcasting, where what used to be national monopolies have been replaced by businesses which can be mobile. The changes that are under consideration would lead to taxation across borders and we are in the process of discussing and coming to, I hope within the next few months, agreement about the mechanisms that would support this new regime which is known in the VAT world as the one-stop shop or the one-stop system. I think one of the things that will do is probably provide a proving ground for the arrangements which allow or involve a greater degree of co-operation and a greater degree of reliance than we have at the moment between one Member State and another in terms of collection of taxation and ensuring it ends up in the right place—

Q359 Lord Maclellan: What does that mean? It begs every question I asked.

Mr Brown: In short it means that the VAT is paid to the Member State where consumption takes place at the rates that are applicable within that Member State.

Q360 Lord Cobbold: Could you not have an automated clearing house where money could be paid to them and then be refunded by that institution to the other Member State?

Mr Brown: I think that is in principle possible. Quite how wise it would be to embark on the computer system that would be required to do that is an interesting point.

Q361 Chairman: I come from a background where clearing and settlement is routine but quite a complex transaction, being as I am a Director of the London Stock Exchange. Are you beginning to suggest that people are working on what is fundamentally a giant clearing and settlement system which clears and settles VAT?

Mr Brown: No. What I am saying is that amongst the options that are being discussed a system which would involve that is one of the things that is under consideration, so it is thinking about the idea rather than having thought about it.

Q362 Chairman: And that system would give you more confidence in the virtue of other people’s fiscal authorities?

Mr Brown: Potentially. It also depends on the patterns when, for example, people make compliance visits and look at what it is they look at within a business’s books. Would they be as interested in looking at tax which was due in another Member State as they are in looking at the tax which is due in their own? Is it potentially one of the attractive things about getting the one-stop system in place, that you begin to get people behaving in that way and you have a base that you can build on and that you potentially can expand in the future.
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17 April 2007 Mr Mike Eland, Mr Tony Walker and Mr Richard Brown

Q363 Lord Maclellan: You gave an answer which was answered again at the beginning in the statement about tax ending up in “the right place”, but there were other points that you might be able to make positively and negatively.

Mr Brown: The risks associated with fraud and non-compliance under the various regimes, because it is inevitable that in any VAT system which has elements of both input tax and output tax associated with it there will be fraud risk and it is making a judgment about the balance of the risks under the different systems, are one of the points to be taken into account. The third point was avoiding creating unreasonable burdens on business, and it is probably worth saying here that it is the case, I think, that businesses will find any alternative to the current regime, which simply requires them to zero rate intra-Community supplies, more burdensome than the arrangements we have at present.

Q364 Lord Kerr of Kinlochard: That does not seem to be the view of the Tax Faculty of the Institute of Chartered Accountants, judging by the paper they have put in. They seem to see some attraction in the Commissioner Kovacs ideas.

Mr Brown: I think the overwhelming view from business is that they prefer the zero rating of intra-Community supplies.

Q365 Lord Blackwell: There is one last option here, and we have the notes of a workshop that was held by the Commission on 29 March where one of the proposals put forward by the Germans, as I understand it, was that the generalised reverse charge, which would be optional and therefore may apply in some cases and not in others, as I understand it, may now become hugely complex. On the other hand, if the generalised reverse charge became a sales tax that would become fairly simple. Clearly the Community went down the route of VAT rather than sales tax some time ago but there are plenty of other countries around the world that apply the simple sales tax rather than VAT. Given that sales tax would avoid these problems of allocating taxes along the way in intra-Community trading, what has the UK Government’s view been on whether this is something that has any merit to be explored or not, and why?

Mr Brown: To start with, in relation to the views about the introduction of sales tax specifically, it is very striking that overwhelmingly, if you look around the world, tax authorities and governments have chosen to adopt variants on the value added tax system rather than sales tax systems. In the OECD countries it is only the United States that does not have a value added tax.

Q366 Chairman: Quite a big country.

Mr Brown: However, they equally do talk about the idea of introducing value added tax from time to time. One of the reasons why more countries have been attracted by value added tax as opposed to sales tax is that the fractionated nature of the payment regime means that there is an element of self-policing within the tax system and that that basically provides you with greater taxing power than you would otherwise have. Very few of the sales taxes which operate get into double figures. We do see value added tax at rates of 20 per cent which appear to be sustainable. In terms of the question about generalised reverse charge, one of the things that is associated with it, particularly in the ideas that the Germans and Austrians have put forward, is that it will add a greater degree of complexity to business because they will have to operate both within the reverse charge system and outwith it if you have a threshold of anything like the sorts of limits that Germany and Austria have talked about, so it would be more complex for business, and I know that the Paymaster General thinks it is certainly not something that she would be interested in pursuing in the United Kingdom were the option to become available to Member States.

Chairman: Thank you very much. I am not sure we have achieved in our own minds, or perhaps in yours, any real answers as to where we should go, but we have had at least considerable illumination of what HM Revenue and Customs are doing and to some extent the Treasury’s thinking. Thank you very much for coming.
Written Evidence

Memorandum by Helen Donoghue, Director, the Charities’ Tax Reform Group

MISSING TRADER INTRA COMMUNITY (MTIC) FRAUD COUNTER-MEASURES

I am writing on behalf of the Charities’ Tax Reform Group (CTRG) in response to call by the Economic and Financial Affairs and International Trade (Sub-Committee A) for evidence following its decision to broaden its continuing inquiry into the issues surrounding MTIC fraud.

CTRG has over 400 members of all sizes representing all types of charitable activity. CTRG was set up in 1982 to make representations to Government on charity taxation and it has since become the leading voice for the sector on tax issues.

CTRG has met HM Treasury officials on behalf of its members to discuss the MTIC proposals. Our views on the MTIC fraud counter-measures proposed by the Government are based on comments received from several members following discussions with them; and although our concerns may not be central to the work of the Committee, we would be grateful if the Committee would note our concerns about the possible impact of the Government’s proposed measures on the charitable sector in the UK.

CTRG welcomed the Government’s willingness to consult in advance of bringing forward draft legislation to tackle MTIC fraud. We recognise the need to tackle MTIC fraud and we understand that the Government cannot exempt charities from its proposed measures given that it must seek to prevent the fraud migrating to new areas. We are, however, concerned about the compliance costs that charities may face as a result of the new measures.

For detailed reasons that are explained below, we urged the Government to increase the proposed de minimis limit of £1,000 to at least £5,000 in order to minimise the adverse impact that the proposed measures may have on charities. We believe that at this level the negative impact of the proposed measures will be minimal for most charities, while meeting the Government’s need to tackle MTIC fraud. Some members have asked for a limit of £10,000, but we appreciate that this may be impractical from HMRC’s point of view and we hope that the Government will regard a limit of £5,000 as realistic. We also suggested that certain small electronic products, such as mobile telephones and BlackBerry-type equipment, should be exempted from the measures if they are tied to UK contracts.

Charities will certainly face additional compliance costs if the Government’s proposed measures are introduced. The proposed new MTIC fraud counter-measures will require some additional VAT training for charity finance officers and may require new systems to be introduced.

If transactions arise that require the reverse charge to be declared in Output VAT, they will be administratively time-consuming and will require someone with a higher level of experience to process these transactions than would normally be the case with ordinary transactions, thus increasing costs. Some of our members also referred specifically to the impact of the measures on training for staff and the need to raise the de minimis limit given the relatively high cost of training equipment, such as video cameras.

We are also concerned that lack of familiarity with the new measures may mean that members who are only very occasionally caught by them will forget to apply them. We believe that this is another very good reason for raising the de minimis level to reduce the likelihood of accidental errors occurring.

One CTRG member is concerned about the impact of the proposed measures on the development of their services for blind people. They are looking at the possibility of supplying specialist MP3 players for visually impaired people and told us this type of device represents the future of their service.

Another CTRG member is “assuming the proposed measure would not apply to items specifically for the personal or domestic use of the visually impaired which we can currently zero rate as a charity”. It would be helpful, therefore, if the Committee could ask the Government to clarify whether products bought by a charity and sold to individual blind or partially-sighted people that are covered by the solely designed relief (and, therefore, zero-rated when they are acquired by the charity) would be excluded from the proposed MTIC counter-measures.

More generally, we would be grateful if the Committee could seek confirmation from the Government that all goods qualifying for zero-rating will be excluded from the proposed counter-measures.
In case it is helpful to the Committee in assessing the likely impact of the proposed measures, I have attached as an appendix the response we received from one member charity which provides an insight into the practical consequences of the proposed measures.

Finally, as members of the Committee will understand, we are concerned that any increase in the range of items covered by these measures will increase the number of charities affected by them.

8 December 2006

APPENDIX

RESPONSE TO CONSULTATION ABOUT PROPOSED MEASURES TO TACKLE MTIC FRAUD

“Our IT team process much of the purchasing for this type of goods on behalf of staff. We would have to introduce a new process to ensure that a copy of all orders placed came to my Financial Accountant—who is responsible for preparing the VAT Return. She would then have to arrange for the correct process to be applied to these. I’m not sure at the moment whether this could be built into our finance software or if this would be a manual process.

Audio equipment is often purchased outside of the IT team. We have recently invested £250,000+ in such equipment. Digital camera/camcorders are also frequently purchased. We would have to communicate the need to alert Finance specifically about such purchases, but would probably have to rely on our own additional reviews of relevant account codes to spot such purchases.

There is a risk that suppliers of this equipment will continue to provide goods with VAT applied. Confusion and hence poor relations with suppliers will prevail.

Our charity makes heavy use of corporate credit cards—120+ staff have these. These types of portable items are often purchased by this method. Monthly card expenditure is imported into our finance system from an electronic file provided by our Merchant provider. We would have to add an additional step to our process to enable checks to take place for such spend, with the appropriate accounting entries being made. With £800,000+ spent annually on cards, this would be an onerous task.

My conclusion is that there are several steps that we could take to monitor spend of this nature, to ensure that we were able to apply the reverse charge. However much depends upon Finance staff becoming aware of such spend in the first place. As we are looking at low value portable items that are purchased by various staff, this will not be an easy task to enforce. My estimate is that software costs of £2,000 would be required, upfront time of approximately four days required for communication and training and an on-going time requirement of one day per month to review invoices, card spend and make adjustments for the reverse charge. Clearly this is not good use of charity staff time.”

CTRG member charity

September 2006

Memorandum by the Chartered Institute of Taxation

INTRODUCTION

1. The Chartered Institute of Taxation (CIOT) is pleased to submit evidence to the UK Parliament European Union Committee in relation to carousel fraud.

2. While the nature and extent of carousel fraud give rise to particular concerns, the CIOT considers that it is appropriate to consider options that will be capable of meeting both current and future attacks on the tax system. In particular, it is important to note that legislation to counter one threat very often simply changes the nature of the threat and so solutions need to take into account likely new threats arising.

3. This paper commences by examining the nature of carousel fraud and then considers the questions set out in the Call for Evidence. In essence, the CIOT believes that fraud arises because it is possible for tax due to HMRC to come into the hands of criminals, and for them to disappear before it is paid over. The key to countering fraud is to prevent this happening, and that requires real-time information.

4. A solution that collects the correct amount of tax by penalising innocent traders is intrinsically unfair, and is likely to be detrimental to business as a whole as well as to taxpayer co-operation.

5. As with other threats to the country, it can be expected that there will be continuing attempts by criminals to attack the system. Accordingly, the long-term sustainability of any system needs to be considered.
THE NATURE OF CAROUSEL FRAUD

6. Carousel fraud arises because EU law allows goods to be acquired by a business in one member state from a business in another without immediate payment of VAT. A return to the system of border controls with VAT being paid on importation would prevent this, but would also hinder the free movement of goods, an essential feature of the single market. Accordingly, it seems unlikely that a return to VAT on importation would be an acceptable solution.

7. As VAT due on acquisition is recoverable in the same return so that no net cash amount is due to the tax authority, a criminal can sell goods to third parties at a price below their normal selling price because there is no intention to pass on the VAT that should be paid to HMRC. Since HMRC will only know that the VAT has been lost when the business importing the goods free of VAT disappears without paying the VAT on acquisition, the key problem is really one of timing.

8. Because the criminal must both sell the goods and collect the cash for the fraud to work, prevention of the fraudulent sale of goods or prevention of the cash being paid to the criminal are the two ways in which the fraud can be countered.

ARE THERE GAPS IN THE LEGISLATION?

9. The heart of the VAT system lies in the fact that registration for VAT carries with it two main consequences, ie:

— the VAT registration represents a licence to collect VAT on behalf of HMRC—in effect, a registered business is given “credit” by HMRC; and

— the VAT registration also allows a business to deduct VAT incurred on taxable and certain other supplies or allows it to acquire goods free of VAT.

There are therefore both output and input tax consequences as a result of being registered for VAT.

10. As already noted, the ability to perpetrate VAT fraud arises because the criminal can engineer a situation where he is licensed to collect VAT for HMRC but has no intention of paying it over to them. However, it should also be recognised that fraud can be perpetrated by hijacking a legitimate business’s VAT registration, ie similar to credit card theft where someone clones another person’s credit card.

11. It will be apparent that, because VAT is a self-assessed tax, it is a feature of the tax that there will always be hundreds of thousands of businesses holding VAT that is payable to HMRC. Striking at the situation where taxpayers are licensed collectors of the tax strikes at the very heart of the system. In the normal course of events, the vast majority of the tax does, in fact, get paid over because most taxpayers are inherently honest, or at least not prepared to commit fraud.

12. Carousel fraud involves a deliberate assault on the system—targeting a particular weakness, but other weaknesses also exist. Further, the “reverse charge” system has its own inherent weaknesses because a business can still acquire goods and sell them without VAT, albeit it is more difficult because sales have to be to individuals and other entities that are not registered for VAT, which means that the logistics of perpetrating fraud on the scale currently experienced are reduced.

13. It is also important to note that the reverse charge has been used for other high-value goods, such as gold and precious metals. The very fact that the scheme has had to be used in other cases suggests that there may be other goods that could be used to perpetrate fraud once the reverse charge is applied to mobile phones and computer chips.

14. The same situation occurs with excise duty, where large-scale fraud occurs in relation to tobacco products so criminals are prepared to smuggle goods into the UK free of duties and sell them on the thriving black market that exists.

15. It should also be recalled that there was wide non-compliance with ordinary VAT regulations until 1985, when new penalties were introduced to deter non-compliance. In essence, therefore, it can assumed that there will be deliberate or innocent non-compliance, whatever the nature of the taxing legislation, unless the system is backed up with measures that identify error in time to prevent any damage to the system.
Measures to Combat Fraud

16. Until the decision of the European Court of Justice in the case of Bond House Systems Limited (and others) v HMRC (Cases C-354/03, C-355/03 and C-484/03), HMRC had sought to deprive certain traders of a right to deduct where the VAT claimed had not been paid over to HMRC as output tax. It was claimed that, because the seller was involved in fraud, there was no business transaction and therefore the “VAT” charged was not input tax.

17. The solution adopted would have curtailed revenue loss but, in the view of the CIOT, was deeply flawed, since it did nothing to target the criminals, and effectively simply sought to prevent revenue loss by making some other, more easily targeted taxpayer, underwrite the tax due from the criminal. Such a solution is deeply offensive to right-thinking individuals, except when the rules of tort (delict in Scotland) apply.

18. Further legislation was adopted in the 2003 Finance Act amending VAT Act 1994 Schedule 11 para 4 to combat VAT fraud. The legislation was challenged in the case of C & E Commrs and Attorney-General, v Federation of Technological Industries (Case C-384/04). The European Court of Justice effectively allowed the measures, but only where the taxpayer “... knew, or had reasonable grounds to suspect, that some or all of the value added tax payable in respect of that supply, or of any previous or subsequent supply, would go unpaid”.

19. The proviso creates serious difficulties in enforcing the legislation because it creates a subjective test whereas, in a self-assessed tax, it is important, as far as possible, to use only objective tests so as to achieve legal certainty. Taxpayers will argue that any HMRC view will be made with the benefit of hindsight while it is difficult to see how HMRC, who have wide powers to access third party information, can really form an opinion of what the taxpayer ought to have known when the transaction was concluded. The CIOT understands that, despite EU case law, HMRC continue to attack taxpayers rather than the actual criminals.

20. FA 2006 introduces measures shifting the burden of accounting for the tax to the recipient of a supply rather than its being paid by the supplier (the “reverse charge”). The reverse charge has been used effectively to counter other fraud such as fraud in the gold market, and was the solution recommended by the CIOT in relation to consultations on carousel fraud.

21. The CIOT considers that the reverse charge is likely to be more effective than other measures. However, it too has flaws. First, it will not be applied to all goods, and no doubt other means of perpetrating the fraud will arise using alternative goods. Second, it applies only to goods when it is conceivable that the means of achieving similar fraud could arise in relation to services because there are instances where the same situation that exists under current legislation in relation to inter-EU acquisitions also applies to services. Third, there is some discrimination against the UK to UK trade, as will be discussed below.

Measures Suggested by the Commission

22. The measures suggested by the Commission are set out in a document entitled “EU coherent strategy against fiscal fraud—Frequently asked questions” (MEMO/06/221 dated 31 May 2006).

23. The Commission advances a number of strategies, including:

— reinforcement of existing co-operation tools between member states and third parties;
— improvement of the exchange of information making use of new developments in information technology; and
— possible more extensive use of the reverse charge.

24. The document also discusses the so-called “definitive VAT system”, or taxation at origin. However, the CIOT notes that this proposal requires considerably greater harmonisation than at present. Many factors militate against this as a solution, including the fact that previous attempts at harmonisation have failed, the investment it would require by business to move to systems capable of dealing with an origin based system and the fact that a new system is more likely to be weak initially. As a means of rapidly responding to current threats, therefore, the solution is likely to fail.

25. The CIOT agrees that the solution most likely to meet the need for immediate and effective action against fraud is likely to comprise a combination of the use of the reverse charge together with better information exchange. Indeed, the emphasis should be on exploiting technology to move to a real-time information exchange, in order to reduce the time that criminals have to achieve their objective—a virtual “flying squad” against tax fraud.
26. The model for the exchange of information already exists in the systems used by credit control agencies across the world. As discussed above, tax held by taxpayers can be regarded as “credit” granted by the tax authorities to taxpayers. Normal business practice is to make checks on the creditworthiness of debtors before granting credit.

27. In a typical commercial situation, credit limits are set on:

   — the debtor based on a combination of his credit history and other factors, eg the fact that he owns property;
   — the size of a transaction, eg a person who tried to use his credit card to obtain, say, £100,000 credit at a restaurant is likely to find the transaction queried even if he has an AAA rating; and
   — other factors, eg a person using a credit card extensively outside his normal place of residence may find that the credit agency contacts him to confirm that it is indeed he who is using the card.

28. In order to combat fraud, it needs to be remembered that the taxpayer seldom has all the information at his disposal to check on a customer. Further, if he is being paid in cash or is paying in cash for goods that can be physically identified, there is normally no incentive or commercial reason why he should do more.

29. The tax authorities (in any country), on the other hand, are in a position to require information and to monitor it to determine whether or not a risk exists. Further, if information is obtained in real time there is a greater chance that they will in fact capture the criminals and cut the problem off at the head.

30. Accordingly, the CIOT is in favour of advancing better information exchange as a solution. However, in doing so, it is important to reduce to a minimum the burdens placed on taxpayers. A system of exchange should therefore provide for:

   — a one-stop shop at which the taxpayer can contact the tax authorities (regardless of where the transaction is to take place) to provide details of specified transactions for clearance;
   — clear guidance of the limits on size of transaction (de minimis limits) where it is necessary to seek clearance—obviously a taxpayer would not seek guidance where he is satisfied that past dealings with the customer/supplier make it clear that he is to be trusted;
   — a commitment by the tax authorities to real-time clearance of transactions in a time frame that does not cause damage to business; and
   — alternative procedures to deal with situations where a transaction may result in a fraud risk, eg an instruction to the customer to apply the reverse charge for transactions that would otherwise not normally be subject to the reverse charge.

31. However, overlaying whatever system is used should be a recognition that businesses exist to make profits and create wealth for investors, employees and other persons in the economic chain. Accordingly, any solution must be proportionate, and should accept the fact that a degree of tax loss is inevitable if business is not to be strangled by regulation.

THE NEED FOR GREATER CO-OPERATION

32. The CIOT agrees with the Commission’s contention that organised crime is a global phenomenon and that, accordingly, it is necessary to tackle the problem on at least a Community-wide basis, and preferably on a global basis.

33. However, the immediate concern of the UK should be the protection of UK tax revenues. The UK should therefore act to introduce proportionate measures and to develop the technology necessary to counter fraud. In doing so, it should recognise that there are existing commercial undertakings that have the experience and, to some extent, the systems that might form the starting point for the information requirements.

34. While the Commission may be best placed to bring forward a Community-wide solution, that should not prevent co-operation with other member states or third party states who may already be developing solutions to defeat tax fraud.

THE IMPACT OF THE ADOPTION OF MEASURES TO FIGHT COMMUNITY FRAUD ON NATIONAL SYSTEMS

35. It has always been recognised that the reverse charge on acquisitions can act unfairly. This is because a business that acquires goods from a neighbouring member state does not have to pay VAT until such time as it makes its VAT return, while the same business would pay VAT if it bought from a local business. This probably does not affect the UK to the same extent as businesses in areas where there are many borders, such as in the smaller European countries.
36. If the reverse charge were applied on a wider basis, it might in fact provide a more level playing field in some cases. However, against this it must be remembered that, where the reverse charge is applied, there remains some scope for loss of the entire amount of VAT because, in cases where supplies are ultimately to end-consumers, a taxpayer can use a VAT registration to acquire goods free of charge and disappear without accounting for VAT on any subsequent sales. This may impose a burden on the policing of the use of the reverse charge within member states, since it is in the member state in which final consumption takes place that the greatest risk will fall.

37. National systems are required to be harmonised with the EC Sixth VAT Directive and, although member states are free to choose the arrangements they wish to make, there are limits, as the decision of the European Court of Justice indicated in the case of Federation of Technological Industries.

38. The imposition of specific invoicing requirements by the “Invoicing Directive” did not appear unduly to burden member states who had to harmonise their systems, largely because the requirements were restricted mainly to information that a business would normally put on an invoice anyway. There does not appear to be any reason why sensible, well thought-out measures should not accord with normal business practice, and so avoid creating any new problems with the policing of VAT.

22 September 2006

Memorandum by Earthshine Ltd

We are writing in response to the EU Select Committee Call for Evidence in connection with the Enquiry into Missing Trader VAT fraud in the EU. We would first like to express how delighted we are that this subject is being investigated in greater depth and hope that it will benefit not only industry, and the taxpayer but allow Her Majesty’s Revenue and Customs (HMRC) to conduct their enquiries more surgically, effectively and without having to continue the current policy of widespread penalisation, disruption and obstruction of established and wholly honest businesses.

Earthshine Ltd was established in order to take advantage of the inflexibility and inability of the main Mobile Phone Distributors to keep pace with demands and trends. Mr Anthony Sharp took control of the company in 2002 and was joined in 2005 by Mr Philip Knatchbull and together they have taken Earthshine forward to the point where we are becoming a Public Limited Company. We have been at pains to establish ourselves as a trader with a reputation for honesty, professionalism and integrity. The corner stones of our business have always been:

(a) Thorough and detailed Due Diligence procedures.
(b) Transparency with HMRC.
(c) Repeat business with tried and tested reputable suppliers, customers and contractors.

We would like to take this opportunity to explain a little more about how we try to conduct our business and our level of compliance and support for legitimacy. Our Due Diligence process primarily serves to protect us from unscrupulous traders. We have been made responsible (by HMRC) for establishing the credibility of our immediate suppliers and customers which we do with uncommon thoroughness. Our Due Diligence procedures from the corner stone of our credibility and follow a successful procedure which has evolved from a simple in-house check to the format we now use; we initially make contact with a potential supplier or customer and receive their company details. We will then task an external agency to investigate that company establishing their credibility and follow a successful procedure which has evolved from a simple in-house check to the format we now use; we initially make contact with a potential supplier or customer and receive their company details. We will then task an external agency to investigate that company establishing their track record, financial standing and credibility, individual company members profile and historical business dealings. From there, that company’s premises will be visited by an Earthshine representative and the external investigator and interviews undertaken and where possible copies of IDs and passports taken in order to confirm identities. In addition, a large number of digital photos of both the individuals present and the premises are taken. We see this use of an external agency as key to providing an independent assessment with greater credibility. This is an exhaustive and expensive process but we feel it vital to protect ourselves but also demonstrate to HMRC that not only do we have Due Diligence of the highest standards but also that we are trying to comply with the unreasonable requests placed upon us by Government agency. It is our belief that we should not be acting as a police force, however, we are at pains to provide as much information as possible.

It is our belief that in order to deal with VAT Fraud, HMRC now follows a policy of disruption and delay using a process called Extended Verification. The required end state seems to be that of delaying or withholding VAT Repayments the end result of which is that the industry is unable to function due to a lack of what is essentially working capital. This policy is currently being applied across the entire industry regardless of the presence or absence of suspicion of wrong doing. In a recent Panorama Programme a spokesperson for HMRC said that they were happy to penalise the innocent in order to catch the guilty. This
can be neither right nor legal. On a human level our relationship with our Customs Officer has always been extremely good. We provide details of every single transaction prior to completion, with follow ups of hard and soft copies sent via recorded delivery. We also make it a priority to comply with HMRC requests by return. However, historically our phone calls have gone unanswered and our letters are referred to a so called faceless “Central Hub”. We have never had a personal response from the “Central Hub” and have been told verbally not to send emails or faxes. We are not provided with telephone numbers nor contacts with whom we can communicate within this organisation and all efforts to do so result in fruitless transfers from pillar to post. When we write to the “Central Hub” we receive no response. We have been asked repeatedly to send additional information which we have done expeditiously and sent by recorded delivery only for HMRC to claim they have never received the information.

Our view point is this: We are a long standing export trader of mobile phones that has the highest standards of Due Diligence to ensure we are trading with legitimate traders and distributors and have always had our input VAT repaid, often after detailed and unnecessary investigation. Our detailed correspondence audit trail with HMRC will confirm this proving we are compliant with HMRC and the Law in every single aspect of our business dealings. As we see it, we are currently doing a great deal of the investigation on behalf of HMRC at our own expense. We understand that time may be required to conduct investigations but we have had repayments withheld since July. This is completely unreasonable.

It is our contention that we are being unfairly and illegally targeted as a result of other people’s wrong doing. We accept that there have historically been wrong doers within the industry and that there may still be those who require investigation. Our point is that as a Government Agency with extended legal powers and thousands of officers available to it HMRC should be able to sort the good from the bad instead of penalising an entire industry for being guilty by association. We have started detailed correspondence with HMRC in order to get VAT repaid and we will be reluctantly issue proceedings in the event that our reasonably put comments are continually rebuffed or ignored.

16 January 2007

Memorandum by Hassan Khan & Co Solicitors

Thank you for the extension of time within which to lodge this submission. As part of its preparation it has been necessary to liaise with a significant number of traders directly affected by HMRC’s approach to tackling MTIC VAT fraud. Whilst for reasons of confidentiality, the names of those clients are not provided in this submission, their views are reflected.

Summary

Hassan Khan & Co Solicitors (“HKS”) and its clients fully support Her Majesty’s Revenue & Customs (“HMRC”) in its aim to eliminate MTIC fraud. As a law firm which currently represents several dozens of traders in the mobile telephone and CPU trading sectors, HKS has been able to closely observe, on a daily basis for several years, the ways in which HMRC has worked to eliminate MTIC fraud and the implications when Court action becomes necessary. This has had varying effects and success. Although a number of measures have been employed, some of which are addressed below, the current lynchpin of HMRC’s strategy is the process of “extended verification” by which HMRC examines in detail the underlying transactions which have given rise to a claim for repayment of input tax credits. The input tax credits are not repaid while extended verification continues. In many cases, this has meant that claimed input tax credits have not been repaid for 12 months or more. The use of this approach by HMRC has also been very widespread, if not wholesale, within the sectors HMRC has identified. This both destroys legitimate businesses and is in breach of Community Law.

From a legal point of view. HKS considers that two main difficulties arise with the HMRC approach:

1. HMRC is mis-applying Community law.

In HKS’s observation. the current measures being employed by HMRC, in particular the process of wholesale extended verification, go beyond what has been confirmed as legally permissible by the European Court of Justice, in the Bond House, Axel Kittel, Federation of Technological Industries (“FTI”) cases and in the recent decision of the Advocate-General in the Teleos matter, released on 11 January 2007.

2. HMRC is potentially using (and overburdening) the UK Courts for an improper purpose.

As a consequence of the measures employed by HMRC, individual traders are being forced to go to the High Court (with its attendant high costs) seeking permission for Judicial Review of HMRC’s failure to make a decision and are being deprived of a judicial remedy in the VAT Tribunal (where
the legal and evidential basis of HMRC’s approach can be tested) by HMRC’s continuing failure to make a decision for an unreasonable period of time. The large number of traders forced to seek Judicial Review in the Administrative Court has clogged the Court list, particularly as HMRC often makes a decision in respect of the claimed input tax credits on the "doorstep" of the hearing. Arguably, this could constitute an abuse of the High Court’s process.

These and other matters are expanded upon below.

**Detailed Submission**

1. **HKS**

1.1 HKS is grateful to the Committee for the opportunity to make submissions on this issue as part of the evidence gathering leading towards the Committee’s Report.

1.2 HKS is a London based law firm which specialises in dealing with indirect tax, customs and excise issues experienced by its clients. It is recognised by Independent Guides such as Chambers & Partners 2006 and 2007 as a leading firm in the UK in the areas of contentious tax and Revenue and Customs. The principal of the firm conducted the Bond House Systems Limited test case ("the Bond House case") in the VAT and Duties Tribunal, High Court and European Court of Justice. This challenged the legality of the HMRC approach of disallowing VAT credits based using the principle of “non-economic activity” in the VAT and Duties Tribunal, High Court and the Court of Justice of the European Communities ("ECJ"). The case is considered to be the landmark VAT tax case of 2006.

1.3 HKS acts for a number of mobile telephone and computer chip traders and currently has conduct of approximately 100 varied tax appeals and Judicial Review cases in the VAT and Duties Tribunal and the High Court.

1.4 HKS and its clients fully support HMRC’s desire to eliminate fraud, however, it is not accepted that the current strategies implemented are actually achieving this objective. Further, the current strategies are disproportionate given that they impact equally severely on established, legitimate and innocent traders, as they do on fraudulent traders. Whilst it is fully appreciated that a loss (or potential loss) to the Revenue of the magnitude estimated in the Pre-Budget Report puts very significant pressure on HMRC (with the assistance of other agencies as required) to act swiftly in curbing this problem. HMRC’s actions to date arguably go well beyond what is permitted by Community law and show a lack of clear targeting and insufficient regard for basic Community law principles of VAT and proportionality, in particular.

2. **Questions**

2.1 As HKS acts for a significant number of traders and has extensive experience in dealing with HMRC, it is able to make an informed contribution to some of the questions raised by the European Union Committee. It has also conducted many cases before the Courts, several of which are lead reported cases in the areas associated with denying VAT repayments and the tax consequences on legitimate traders’efforts to tackle MTIC fraud.

2.2 HKS considers that it is most appropriate for it to address the first two key questions raised in the Call for Evidence; however, it considers that those questions are best considered in reverse. We will also briefly consider question 3, specifically, the principle of mutual assistance by Member States; therefore, this submission will address the questions as follows:

What are the measures currently applied in the UK and other Member States to combat this fraud and what are their weaknesses?

What impact does this fraud have on the internal market?

The Commission has suggested measures including increased cross-border liaison tax and law enforcement authorities and Governments, improved risk management, and mutual assistance by Member States wishing to recover unpaid taxes. Are these mechanisms adequate?
3. What are the measures currently applied in the UK and other Member States to combat this fraud and what are their weaknesses?

3.1 The material published with the Chancellor’s Pre-Budget Report to the House of Commons in December 2006, indicated the Government’s strengthening of strategy to combat MTIC fraud as being directed on four different levels, namely:

3.1.1 Identifying and prosecuting the criminals behind the fraud;
3.1.2 Working internationally to combat cross-border fraud;
3.1.3 Identifying and tracking those goods most susceptible to MTIC fraud; and
3.1.4 More in depth checking of suspect repayment claims.

3.2 HKS and its clients fully support the first three of these four central strategies. Although it is considered (in respect of item 3.1.3) that the practical implications of HMRC’s decision to introduce the legal basis in the Finance Act 2006 to require traders to keep IMEI (International Mobile Equipment Identifier numbers) of mobile telephones was very significantly understated in its Regulatory Impact Assessment. Traders do experience significant difficulties with the cost, accuracy and effectiveness of attempting to retain IMEI numbers. In this submission focus is on the way in which it appears that HMRC is putting the fourth limb of the strategy into place and the consequences of these measures. since this has the most disproportionate effect on legitimate traders.

3.3 A more detailed analysis of how this strategy has been put into practice illustrates that HMRC has implemented the following:

4. Extended verification

4.1 HMRC’s current policy of widespread “extended verification” appears to have been instigated following the release of the Bond House decision by the European Court of Justice in January 2006.

4.2 The Bond House case involved an aggressive line taken by HMRC in its fight against “carousel” or MTIC fraud in which HMRC decided that they would disallow the input tax claimed by legitimate traders involved in a transaction chain where one or more of the other traders were said to be fraudulent, such that if an innocent business was unknowingly involved in a trading chain, one part of which was alleged to be undertaken for VAT fraud purposes, that entire transaction chain was considered by HMRC to be a “non-economic activity” and they could not reclaim input VAT. In practice, the trader of exporting the goods was deprived of their input tax reclaim whilst HMRC paid back VAT elsewhere in the chain. The VAT and Duties Tribunal supported this view and the decision was appealed to the High Court, which referred the case to the ECJ.

4.3 HMRC’s policy predominantly affected businesses in the mobile phone and computer hardware industries, but had worrying implication for other business sectors. These two business sectors had been very badly hit forcing many to suspend trading and some to enter into liquidation, as was the case with one of the appellants in the Bond House case.

4.4 In January 2006, the ECJ delivered its decision in the Bond House case, agreeing with the Advocate General’s earlier position and unequivocally disagreeing with the analysis of HMRC and the VAT and Duties Tribunal. The ECJ held that a taxable person’s right to deduct input tax must be assessed individually and cannot be affected by the fact that in the chain of supply of which those transactions form part, another prior or subsequent transaction is vitiates by VAT fraud without that taxable person knowing or having means of knowing of that fraud.

4.5 This approach was confirmed by the ECJ case of Axel Kittel in July 2006, where the ECJ made a number of observations, being, primarily:

4.5.1 Preventing tax evasion, avoidance and abuse is an objective recognised and encouraged by the Sixth (VAT) Directive.

4.5.2 Where the tax authorities find that the right to deduct has been exercised fraudulently they are permitted to reclaim repayment of the deducted sums retroactively. It is a matter for the national Court to refuse to allow the right to deduct where it is established, on the basis of objective evidence, that that right is being relied on for fraudulent ends.

4.5.3 Traders who take every precaution which could reasonably be required of them to ensure that their transactions are not connected with fraud, be it the fraudulent evasion of VAT or other fraud, must be able to rely on the legality of those transactions without the risk of losing their right to deduct the input tax.
4.6 In light of the Bond House decision, HMRC has concentrated its efforts in establishing that individual traders had the “means of knowing” that VAT would go unpaid somewhere in their supply chains. This has resulted in the widescale “extended verification” of VAT Returns. Extended verification has been one of the most significant policies implemented by HMRC by which they block VAT refuses to pay input tax refunds until they have completed their enquiries in relation to the underlying transactions. The process of extended verification generally involves numerous site visits and multiple demands for (frequently the same) documents from traders and a full examination of all traders in each supply chain. Many traders have become so disconcerted by HMRC’s actions and approach that they instruct their legal or accountancy representatives to be present at such visits. This increases legal costs, particularly where HMRC could have made a single request for information at the outset.

4.7 HKS does not dispute HMRC have a reasonable opportunity to make reasonable enquiries within a reasonable timeframe, however, HMRC’s extended verification strategy goes well beyond those parameters. The December 2006 Pre-Budget Report stated that “the vast majority of suspect repayment claims are now subject to in-depth checking and will not be paid unless and until found to be properly payable”. This is an incorrect starting point. Such a “guilty until proven innocent” approach is contrary to Community law (in particular, Article 17 of the Sixth VAT Directive) which recognises that there is an immediate right to deduct input VAT. This right is then only liable to be interfered with if, in relation to each individual transaction, it is in pursuance of the purpose of preventing tax avoidance, evasion or abuse. HMRC are not adopting a refined, balanced approach in this respect. It is clear that since March 2006 (VAT Accounting Period 03/06) HMRC have blocked input tax reclaims to almost every trader in the sectors targeted.

4.8 Nor are HMRC permitting any scope to argue special circumstances. No distinction is being made between established traders who practice extensive due diligence, have no tax losses and comply with all guidance notes, and those that do not (whether they are actually engaged in fraud or not). The HMRC position on interim payments is confused and results, in every instance, in a decision to deny interim payments regardless of the strength of the request or supporting independent expert accounting evidence.

4.9 Until HMRC make a decision either to repay or disallow the input tax claimed, traders have no other avenue of redress, except to seek permission from the High Court for a Judicial Review of the reasonableness and procedural propriety of HMRC’s actions in withholding repayments on the grounds of extended verification. This is a long and expensive process in itself and forces traders to divert yet more resources away from their businesses, further threatening their ability to continue to trade. This prolonged failure to make a decision is depriving traders of an effective legal remedy. In several cases HMRC have made a final decision the day before a hearing for Judicial Review has been listed for hearing. This raises serious questions about HMRC’s approach to the proper administration of VAT.

4.10 The “extended verification” strategy has also extended to the failure of the Commissioners to pay the VAT reclaimed on overheads. Many traders have received no payment at all. HMRC has no clear or consistent policy on how to approach this (or at least that his the practical consequences of applying any policy that does currently exist) and the only reason which has been provided for the delay in repayment has been the verification of “supply chains that may be tainted by fraud”. It is difficult to see any sustainable connection between verification of “supply chains that may be tainted by fraud” and the recovery of input tax on overheads which have been incurred by traders. It is unclear as to what additional verification the Commissioners might be carrying out in relation to overheads and indeed how such enquiries would constitute “reasonable enquiries” within the meaning of section 79 of the VAT Act.

5. Changing traders VAT Accounting Period Returns from monthly to quarterly

5.1 It is understood that the aim of this strategy is to reduce losses arising from MTIC fraud by reducing the frequency of VAT repays.

5.2 This strategy has been applied by HMRC inconsistently. In addition, in 2006 HMRC formulated a new policy in relation to the strategy without that policy being communicated to traders. There are concerns both with the legality of the policy and that a new policy is being implemented without it being brought to the attention of affected parties, so that they are aware of the regulatory landscape within which they are expected to operate.
6. Deregistration

6.1 HMRC have taken the step of deregistering traders for VAT purposes who may have temporarily stopped making supplies or trading. This is an aggressive and often misplaced strategy.

6.2 In most circumstances, traders have temporarily ceased trading solely as a consequence of cash-flow issues resulting directly from HMRC’s own withholding of input tax credits. Many traders in the mobile telephone industry have been forced into this position due to the withholding of VAT reclaims. However, once weakened in this disproportionate way, HMRC have then threatened them with deregistration. Such a threat is arguably an abuse of the deregistration powers contained in Schedule 1 of the VAT Act 1994 as the reason that trade may have temporarily stopped is a direct result of HMRC’s actions. HMRC are obviously aware of this. These cases are then the subject of appeals to the VAT and Duties Tribunal causing further expense for trader, HMRC themselves and the taxpayer through unnecessary burdening of the VAT Tribunal and increased costs.

6.3 In addition, some HMRC officers have, it appears, used deregistration as a de facto penalty measure. For example, in one case where, upon an HMRC officer attending a trader’s premises for a site visit and finding the premises unattended (that morning), the HMRC officer deregistered the trader immediately. This is an example of deregistration being used for a purpose other than that which was legislatively intended.

7. Set off of unpaid direct tax liabilities

7.1 HMRC is also now seeking to pursue traders for unpaid direct tax liabilities including Corporation tax, PAYE and NIC. Given that HMRC are withholding funds that, in many cases, are sufficient to extinguish by several multiples the direct tax liabilities and represent substantially all working capital, traders are obviously seeking to set-off the direct tax liabilities against the withheld VAT.

7.2 HMRC appear to be adopting an unstructured approach, which has led to inconsistencies with some traders being threatened with debt recovery proceedings while others are not.

7.3 This is yet a further “policy” which has emerged with an inconsistent approach and little or no publication of the policy itself. Its effects are wide-ranging, damaging and in many cases entirely disproportionate. No legitimate business disputes its need to pay direct tax liabilities but great exception is taken to debt recovery procedures being used for tax liabilities held by the same Department withholding much larger VAT reclaims, including those incurred on overheads.

8. Litigation

8.1 HMRC are increasingly willing to engage in litigation to implement their policies.

8.2 While civil litigation may well serve to increase the financial risk for fraudsters and thereby act as an indirect deterrent, it also increases the risk for legitimate traders, given that no differentiation is made in withholding repayment between those with knowledge or means of knowledge of fraud and those lacking any such knowledge or means of knowledge.

8.3 Many traders are being forced to pursue Judicial Review proceedings in the High Court, simply to get a decision which, if unfavourable, may then be appealed in the VAT and Duties Tribunal. It is becoming increasingly apparent that HMRC are holding off making a decision until the eve of the Judicial Review hearing, thereby depriving traders of a decision for as long as possible. In addition to constituting an arguable abuse of the Court’s process, this is actually incurring additional cost to HMRC in terms of the legal costs involved in defending the judicial review until the eve of the hearing. This cost and the use of the Courts resources is being borne by the taxpayer.

8.4 HKS has many clients who have waited many months (many since March 2006) for HMRC to make a decision following the “extended verification” process. Given the successive requests by HMRC (often for documents that have already been provided) many traders have determined that they have had no option but to issue High Court proceedings applying for Permission to apply for Judicial Review of HMRC’s failure to make a decision and unreasonable delay. This is the only recourse available to traders in this position. In many cases an application for urgency has either accompanied the permission application, or has followed it, once it has become clear that the trader in question may be forced to wait many more months before the permission application is even considered on the papers by the Courts. In most cases that HKS has been involved in, the time taken from a trader first being advised that it is subject to “extended verification” and the hearing of the permission application (even with an urgency application) has exceeded six months.
8.5 Frustratingly, in a number of cases, HMRC have determined to reach a decision (to date always to disallow repayment of VAT) a matter of days prior to the hearing. Only then can the trader appeal the decision in the VAT and Duties Tribunal, necessitating greater expense and further delays. Although, in theory, it is open to the trader to continue the proceedings in the High Court in an attempt to obtain a ruling on the reasonableness of HMRC’s delay, in reaching a decision (despite a decision having been made) and to scrutinise HMRC’s actions. However, some Judges have taken the approach that the purpose of bringing judicial review proceedings is to purely to push HMRC to make a decision and have determined that:

8.5.1 It is inappropriate for the Administrative Court to make a decision regarding the merits of the decision to deny the input tax claim as it is outside the Court’s jurisdiction.

8.5.2 It is not a proper use of the Court’s time to carry out what would be a lengthy investigation on whether or not HMRC should have made a decision earlier and whether HMRC’s legal position is incorrect.

8.5.3 Proceeding to judicial review also exposes a trader to a costs order against no matter how late HMRC’s decision before the hearing.

8.6 This places traders in an extremely difficult position, as they are unable to obtain any legal certainty in this area. Many traders have more than one monthly VAT input tax refund owed and are, therefore, on occasion required to issue multiple judicial review proceedings, before then proceeding with multiple appeals (each in relation to a separate VAT return, and in relation to different portions of those returns where, for example, a decision to disallow has been made in relation to particular transactions and not others) in the VAT and Duties Tribunal.

8.7 Clearly, forcing legitimate traders to go to such lengths in an attempt to have their VAT input tax repaid, is disproportionate in the extreme. Indeed, in one case HMRC, through Counsel, stated in the High Court that their view of the right to deduct input tax contained in the 6th EC VAT Directive was that it was not applicable until the end of an HMRC investigation and ultimate outcome of consequent proceedings. To suggest that traders have no right to deduct input tax for what is in this type of instance, two year, is plainly without merit, absurd and a clear breach of the legal requirements of the 6th Directive.

9. Reverse Charge

9.1 HMRC asserts that the reverse charge derogation will remove the mechanism for VAT fraud on most affected goods. However, since all 27 Member States must agree to the derogation from the Sixth VAT Directive before the new tax regime can be implemented, there is considerable doubt about whether all Member States will agree to the measure as currently proposed, given that one effect of the proposed derogation may be to displace VAT fraud to other Member States which do not have, and have not requested, a derogation.

9.2 Fraudulent traders are likely to have moved on to trade in a different industry where reverse charge is not proposed to be applied, but if not, are likely to do so prior to the implementation of the measure. Regulations will need to continually be made to stop MTIC fraud from successfully mutating to other goods.

10. Joint and several liability for unpaid VAT

10.1 HMRC obtained the power in 2003 to impose joint and several liability for unpaid VAT on traders dealing in goods in which the chain of transactions includes a trader who has not paid VAT.

10.2 On 11 May 2006, the ECJ delivered a decision on joint and several liability in the FTI case. The ECJ was asked to provide a preliminary ruling on the compatibility with EC Law of sections 17 and 18 of the Finance Act 2003 which implemented s77A of the VAT Act 1994. Those sections were enacted to deal with the fraudulent abuse of the VAT system by providing for the joint and several liability of taxable persons for VAT in certain circumstances.

10.3 The ECJ accepted the arguments made by HMRC and ruled that the Member States are permitted to enact legislation which provides that a taxable person may be made jointly and severally liable for the payment of VAT in circumstances where that person knew, or had reasonable grounds to suspect, that some of all of the VAT payable in respect of a supply of goods or services would go unpaid.

10.4 The ECJ recognised that legitimate traders are entitled to protection from the joint and several liability provisions to the extent that traders “take every precaution which could reasonably be required of them to ensure their transactions do not form part of a transaction vitiated by VAT fraud.”
10.5 The ECJ also provided guidance on the rebuttable presumptions directed at establishing that a taxable person knew or had reasonable grounds to suspect VAT would go unpaid. In particular, the ECJ noted that the presumptions "may not be formulated in such a way as to make it practically impossible or excessively difficult for the taxable person to rebut them with evidence to the contrary".

10.6 Although the FTI case seemed to provide clear guidelines, these have not always been implemented by HMRC. Given that HMRC’s policies are often not communicated to traders and/or that this is done inconsistently, it makes it particularly difficult for traders to “take all precautions” in ensuring that their transactions do not form part of a chain involving fraudulent trades. Even where traders practice extremely rigorous due diligence and take reasonable precautions, their VAT reclaims are still being made the subject of the extended verification process. It is understood HMRC are experiencing difficulty with the practical implications of applying the Joint and Several liability provisions.

11. What impact does this fraud have on the internal market?

11.1 As far as we are aware at present, it appears that no mobile phone trader has been paid its full VAT input tax refund since about April 2006, although there have been some instances in which interim repayment for the VAT incurred on overheads has been made. Traders’ compliance with the guidance notes or legal regime has not provided any measure of protection to exporters. The weaknesses of the current measures are that they are not directed at fraudulent traders, or the fraud itself, but at all traders in the mobile phone and computer chip industries in general. The current strategy is preventing legitimate traders from trading and driving legitimate traders out of business. This also acts to restrict exports, which has an effect on the UK’s trade position generally. In so far as this affects intra-Community trade in such goods, it is well established that national measures may only interfere in so far as strictly necessary with the free movement of goods within the EU. The question arises very significantly from HMRC’s measures, as applied by them, whether in many cases the action being taken by them is disproportionate and goes beyond what is necessary to achieve the legitimate aim of preventing tax evasion, avoidance or abuse. This has not yet been fully tested due to the great difficulty of obtaining a decision from HMRC by virtue of their policy of extended verification. It is another example of the effect of traders being deprived of a legal remedy for an unreasonable period of time.

11.2 The existing measures have not brought MTIC fraud to an end, in part because MTIC fraud may be diversifying both in terms of the types of products being traded and the way the fraud itself is structured. At the same time a significant number of traders have ceased trading due to the financial pressure of having significant sums (often many millions of pounds) of VAT input tax refunds withheld. Traders in these industries are often reliant on prompt repayment of these sums as their working capital. Even where traders may have the finances to continue trading, they may have ceased in the knowledge that their VAT input tax refund will be withheld. This quite clearly applies to innocent traders also, given that HMRC is failing to make any discernible distinction between traders and has determined to implement the current strategy of withholding all VAT input tax refunds for traders operating in the mobile phone and computer chip industries. Further, this strategy fails to take into account a trader’s individual circumstances and adherence to all practice guidelines given by HMRC, with respect to due diligence and all other information requested and provided by traders to HMRC.

11.3 As specifically stated by the ECJ in the FTI case, traders who take every precaution which could reasonably be required of them to ensure their transactions do not form part of a chain which includes a transaction vitiated by VAT fraud must be able to rely on the legality of those transactions without the risk of being made jointly and severally liable to pay the VAT due from another. This principle is likely to be of general application to any situation in which HMRC try to hold one trader liable for the actions of a fraudster. Indeed the ECJ also held in the Axel Kittel case that the question of whether the fiscal authorities have actually collected tax (in a prior supply) is not relevant to the right of a taxable person to deduct input tax.

11.4 In the recent ECJ case of Teleos, the Advocate General’s Opinion (published on 11 January 2007) expressly warned against the disproportionate burden being placed on the suppliers of goods that may create an obstacle to the movement of free goods. It was stated that the risk that the supplier might be liable for VAT in the event of its purchaser not actually exporting the goods, but feigning transport by means of fraudulent transport documents, could deter the supplier from trans-frontier transactions.

11.5 While the Advocate-General recognised that the Sixth VAT Directive recognised that the fighting of tax evasion may justify some restrictions on the free movement of goods, he considered that the approach advocated by the Member States in Teleos would lead to an unreasonable allocation of risk between the supplier and the revenue authority in relation to the criminal conduct of a third party and considered that this would offend the principle of proportionality. This is a further area where the measures being employed are distorting the internal market.
12. The Commission has suggested measures including increased cross-border liaison between tax and law enforcement authorities and Governments, improved risk management, and mutual assistance by Member States wishing to recover unpaid taxes. Are these mechanisms adequate?

12.1 Presently, HMRC often claim that the delays in the extended verification process are as a result of the delays involved in HMRC’s enquiries with Member States and the slow response. The possibility of a quicker and more detailed exchange of information between Member States would be beneficial to legitimate traders who have in the past regularly been advised that the process of extended verification cannot be completed due to outstanding enquiries with other Member States.

12.2 While the principle of mutual assistance seems beneficial, in practice the current regime only requires Member States to respond to enquiries in six months. HMRC then has an additional two months in which to request the authority to continue its investigations. In theory, this provides an opportunity for up to eight months delay in the verification of returns (and possibly longer if additional investigations are requested). This process would be much improved by a more efficient and transparent cross-border liaison between tax and law enforcements authorities and governments.

13. Conclusion

Whilst all legitimate traders favour the reduction of tax fraud in their marketplace, the current measures by HMRC are disproportionate, often indiscriminately targeted and seem aimed at the elimination of the marketplace itself rather than the fraud occurring within it. Over time this will further damage the UK’s intra-Community trade position, reduce indirect tax receipts from value added components in the UK supply chain, and reduce direct tax receipts through reduced trading, loss of employment, business closure, and relocation to outside the UK. It will also almost certainly in due course result in very significant damages claims against the UK for failure to adhere to basic accepted principles of Community law.

31 January 2007

Memorandum by the Institute of Chartered Accountants of Scotland

Many thanks for your letter of 8 December 2006 and the invitation to present evidence to the European Union Committee on Missing Trader Intra Community Fraud (MTIC).

MTIC fraud occurs because imported goods across EU borders takes place without VAT being imposed in the country of origin. Such an arrangement was supposed to be a temporary arrangement while members harmonised their VAT systems and rates.

It is abhorrent that criminals have been able to abuse the system in such a way that they fraudulently obtain money and place at risk the integrity of the system, undermining the confidence which ordinary taxpayers have in the system. In principle such activity is intolerable and we at the Institute of Chartered Accountants of Scotland are anxious to do all that we can to eliminate the fraud.

During 2006, we issued a copy of the letter attached at Appendix 1 to all our members. This was intended to raise awareness of the fraud helping those who might otherwise become embroiled to identify the risks. We also published in our CA Magazine an article (Appendix 2) highlighting the risks and identifying the warning features.

Newspaper coverage throughout 2006 has been a cause of concern. By the summer of 2006, according to the Guardian, the Office of National Statistics estimated that £10 million was being lost to criminal activity in one quarter of the year. A fraud at such a level would be of a concern to every citizen because it would force the Government to raise tax. It is in the public interest that such fraud must be stopped. The existence of such levels of fraud within the UK alone must have a detrimental impact on the internal market. It indicates that the current structure of the internal market is seriously flawed. There is concern that the major economies of Britain, Germany, France and Italy are most at risk and anecdotal evidence suggests that the UK fiscal authorities have been relatively successful in challenging the fraud. The policy of more careful examination of repayment claims has identified fraudulent activity which has then seen the successful rejection of the repayments. The anecdotal evidence suggests that the fraudsters have transferred their activity to other fiscal jurisdictions as well as diversifying their activity into other goods.
More generally, fraud at such a level on any fiscal system undermines the acceptability and integrity of the fiscal system. Honest taxpayers will be concerned if they think that fraudsters are abusing the system and fraudulently extracting money.

Evidence of greater cross border co-operation to challenge MTIC fraud is to be welcomed. In August, the successful operation mounted by HMRC and its European counterparts, officials from Zollkriminalant, Germany’s Customs department, were deployed in the Swiss/German border and at Frankfurt Airport to monitor the movements of goods into the European Union. The serial numbers of over 30,000 mobile phones were scanned and compared with others in HMRC’s nemesis database and uncovered evidence of MTIC fraud. The extension of legislation empowering HMRC to mark goods identified as being at risk enables the fiscal authorities to track those commodities that have in the past been used to make fraudulent claims across EU borders. This can only be one element of the anti MTIC strategy but it is a good example of the kind of international co-operation which will tackle MTIC fraud quickly and effectively for specific goods. The risk is that the fraudsters will then use a different type of commodity rather than, as in this case, mobile phones.

Improved intelligence should help to identify data which suggests that international trade may be a risk factor being abused by potential fraudsters. If, for example, there is no substantial manufacturing activity of specific high value goods and yet goods are being exported, there must be a risk that in the absence of an obvious commercial reason for such an export trade, the economic motivator is the fraud involving VAT. As a general principle, the Commission’s suggestion to increase cross border liaison by tax and law enforcement authorities and governments should lead to improved risk management and a better challenge. Only time will tell whether these mechanisms are adequate but they would, in the short term, appear to be effective in helping the UK combat MTIC fraud.

In MTIC fraud, the goods are merely a means to give structure to the transaction. Effectively, it is the VAT or purported VAT that is the economic driver and that is what is being traded. As there is no true economic purpose to the transactions, they are arguably outside the scope of VAT and it is arguable that input tax is not recoverable. This was the underlying principle to the 2003 legislation denying the recovery of input tax to traders involved in the chain. Arguably, they should be held as joint and severally liable if they negligently became involved in a carousel chain with the purchaser appearing to be the buffer.

One way which HMRC attempts to stop the carousel fraud is at the stage of considering an application to register for VAT. This acts as a deterrent to the potential fraudsters but it can cause considerable additional cost and inconvenience to honest traders wishing to register. The significant delays in processing registration applicants are generally unwelcome and the UK compares poorly with other jurisdictions in this regard. Customs are able to exercise a further level of control by requiring some traders to obtain Customs approval on a daily basis before finalising a transaction. Such traders must send to HMRC details of sales, purchases, customers and suppliers so that HMRC can monitor transactions and using risk assessment try to stop VAT fraud.

The 2003 legislation attempted to make persons in a supply chain jointly and severally liable for VAT that has not been paid by a missing trader where they knew, or had reasonable grounds to suspect, that VAT would go unpaid. The measure applies to goods of a specified description and the risk is that fraudsters will merely use goods that are outside the specified descriptions which currently includes telephones, computers and certain high value related components.

In contacting ICAS members and publishing articles on how to identify and combat fraud, ICAS has been trying to prevent the fraud occurring. It is in everyone’s interests that commercial organisations should take reasonable steps to enquire into the legitimacy of customers, the economic viability of transactions and the preservation of redress if the vendor is not able to transfer proper legal title.

At the time of writing, the UK Government and HMRC has been frustrated in seeking to impose a reverse charge mechanism on certain goods. There is a concern that such an approach would not be effective as it might transfer the problem to another EU country or alternatively it might change the nature of the goods used to give the transactions some structure. In inviting evidence, the Committee asked whether these mechanisms are adequate. It is difficult to answer that question because of the lack of empirical evidence but we are confident that the visible prosecution of fraudsters and the improvement in identifying goods being transferred and risk assessment all act as significant deterrents to the fraudsters. The fraudsters are however manipulating the temporary VAT regime which is being shown to be defective. The solution must be that member states have a responsibility to fight individually against this fraud and to do all that they can to prevent it. It is also right that the Commission should bring forward proposals and a potential solution would be to reconsider the VAT scheme and move from the temporary arrangements towards an origin scheme as was the original intention.
The final question posed by the Committee is to attempt to quantify the benefits and costs of moving from the current destination system to an origin system. We are unable to comment on this. A significant variable in attempting to answer this question must be the lack of harmony in the VAT tax rates between different member states. This raises issues of sovereignty. We believe that simplification and restructuring of the VAT system has much to commend it but we refrain from commenting on VAT tax rates as this would appear to be a political decision.

APPENDIX 1

HELP STOP TAX FRAUD

Dear Member

RE: TAX FRAUD “MTIC FRAUD”, “CAROUSEL FRAUD,” “MISSING TRADER FRAUD”

I am sure that you will be aware of the recent public comments from HMRC on the subject of this fraud (estimated by the Treasury to cost the UK over £1 billion a year) which has a number of names, but is most commonly known as Carousel fraud.

Many of you will also be aware of the recent European Court of Justice ruling which found for three UK companies against HMRC—HMRC had refused to allow VAT Input credit for companies caught up in the frauds.

The fraud itself involves moving goods around a supply chain where one or more of the parties are acting fraudulently. So for example, a VAT registered supplier of mobile phones in France, sells taxable handsets to Mr Jones, a VAT registered trader in the UK. This is a cross-border, zero-rated transaction.

Mr Jones then sells the goods on to another VAT registered trader, Mr Smith, charging and receiving VAT for the sale. Mr Jones then disappears, having failed to hand over the VAT to the tax authorities. He is now a “missing trader”. His behaviour is certainly fraudulent, and the tax authorities would be left out of pocket after refunding Mr Smith, who has acted innocently in the chain. It is also an easy fraud for a criminal to perpetrate; it requires virtually no infrastructure or the physical signs of the carrying-on of a business, needing little more than a telephone and a VAT-number to accomplish it.

The ECJ case was significant. It was brought by three UK companies at the end of a supply chain, because the HMRC refused to refund the VAT to them, even though the companies had no knowledge of the Carousel fraud that they were innocently caught up in.

The ECJ ruling, which was complex and should be considered in detail, said that “The right of a taxable person to deduct VAT cannot be affected by the fact that, without that person knowing or having any means of knowing, another transaction in the chain is vitiated by fraud.”

There is no evidence that the clients of any ICAS member have, as yet, been caught up in Carousel fraud, but it is certain that Scotland is not immune to this recent phenomenon (there are recent examples of otherwise plausible people who are not who they claim to be) and it would perhaps be helpful for members to remind themselves of the steps which they could take to mitigate risk when accepting clients or more generally advising existing clients.

Here is a short summary of simple-to-implement checks:

Are you satisfied that it is a bona fide business operation?

Are you satisfied that there are no concerns regarding the integrity of the owners, directors and management of the client/entity?

THE CASE OF THE VANISHING VAT

Losing your shirt is bad but losing your reputation is worse. Derek Allen looks at warning signals of carousel or missing trader fraud

Carousel fraud cost the UK—and that means all of us—over £1 billion last year and even more in earlier years. MTIC—Missing trader intra-community fraud, more commonly known as carousel fraud—is a big problem for everyone including professional advisers and HM Revenue and Customs (HMRC). It’s a big problem because it is so easy to do—you need little more than a telephone and a VAT number.
It works like this. Using the example of mobile phones, an overseas VAT registered supplier called Bloggs offers taxable handsets and sells a batch of phones to Jones, a VAT registered trader in the UK. This is a cross-border, zero-rated transaction.

Jones then sells the phones to another VAT registered trader, Smith, charging and receiving VAT (at 17.5 per cent). Jones may issue a VAT invoice to Smith, so that he can reclaim the tax. Jones then disappears, having failed to hand over the VAT to the tax authorities. He is now a “missing trader”. His behaviour is certainly fraudulent, and the tax authorities would be out of pocket after refunding Smith, who may have acted innocently.

The credibility of the transactions may appear to be enhanced if other traders can be ensnared, creating a chain and acting as a buffer to hide Jones’s fraud. At the end of the chain the customer sells the goods as a zero-rated supply to a registered trader—possibly Bloggs again in another member state—and the goods keep circulating. Looked at overall, the goods are merely a means to give structure to the transactions. It is effectively the VAT, or purported VAT, that is the economic driver. It is a nasty fraud that hurts everyone. It is in the public interest to make sure that it is stopped.

Carousel fraud has reappeared as a major issue in recent weeks because of a highly significant verdict at the European Court of Justice (ECJ). Three companies, Bond House Systems, Fulcrum Electronics and Optigen made a joint case against HMRC over withheld VAT. They were unwittingly involved in a carousel fraud. HMRC had tried to deny VAT to them, on the basis that they were involved in “non-economic” activity, even though the firms had acted innocently. The companies argued that this was unfair, and the ECJ ruled in their favour.

The case could cost the government hundreds of millions of pounds as companies that have found themselves in a similar situation will seek to reclaim the tax. It is no surprise that on the day of the ECJ verdict, Dawn Primarolo, the Paymaster-General, announced that she would look at every way possible to prevent carousel fraud, including legislation if necessary. ICAS supports this principle and will do all that it can to stop this fraud.

Treasury civil servants will be scrutinising the ECJ judgement and will be interested in one line in particular. To reclaim VAT, the test that a trader must pass, if there was a fraud in the chain of transactions, is that they must demonstrate that it was “… without the taxable person knowing or having any means of knowing”.

This means that clients and advisers should do everything that they can to show that reasonable precautions have been taken to find out about a transaction and the backgrounds of those involved. ICAS issued a letter to members in January with a reminder of the importance of verifying the identity of a client—it is essential to be able to show that this has been done.

HMRC can confirm whether a person’s VAT registration details are current and valid. It is good practice, if you have any reasonable doubt, to check VAT registration details with the National Advice Service (NAS) on 0845 010 9000.

Even innocent involvement in a carousel fraud could involve loss of reputation

Carousel fraud has usually concentrated on high value items such as electrical goods, silicon chips and LCD screens but there is some evidence that it is now spreading to items such as clothing. The criminals are perpetrating lower value frauds, but more of them. Everyone must be on guard, and here are some of the signs of which to be wary:

— goods that are well-travelled and/or have come through a number of member states;
— wear and tear on packaging;
— suspiciously low prices;
— unknown suppliers; and
— false VAT numbers, or a false invoice.

Carousel fraud looks as if it is here to stay. We want to stop it. Members must be aware that if any of their clients do become unwittingly involved in a fraudulent chain, they should be in a position to show that they have taken every reasonable precaution to find out about the transaction and the people involved in it.

HMRC tries to stop carousel frauds when it considers an application to register. If it monitors applications successfully so that a fraudster cannot register, he cannot participate in a fraud. But this delays the process of registration for everyone and adds to the cost and inconvenience.
Even innocent involvement in a carousel fraud could involve considerable loss of reputation and substantial costs of proving innocence. Prevention is better than cure and this article should help to alert members to the risk of getting caught on the carousel.

*Derek Allen*, Director of Taxation at ICAS

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**Memorandum by Robert W Maas, The Institute of Indirect Taxation**

I am writing on behalf of The Institute of Indirect Taxation in response to your recent call for evidence to assist your Committee’s Inquiry into MTIC fraud.

The Institute of Indirect Taxation is a professional body representing indirect tax practitioners. It was formed in 1991 and has approximately 500 members and 150 students for its examinations. The membership comprises solicitors, accountants, barristers and other practitioners in indirect tax. Many of its members are ex-HMRC staff, and serving officers of HMRC are both members and students of the Institute.

*What impact does MTIC fraud have on the internal market?*

The European Commission has estimated that tax fraud, a major part of which is MTIC fraud, accounts for between €200 and €250 billion throughout the EU as a whole (EU Tax Policy Strategy 5 September 2006). MTIC fraud is not peculiar to the UK. It is also a problem in other EC countries. Last year not only the UK but also Germany and Austria applied for derogations to introduce a reverse charge to combat this fraud.

MTIC fraud exploits a design fault in the structure of VAT. VAT is normally imposed on the value added by a trader. A trader who buys goods pays his vendor the VAT on his purchase price, so if he disappears without accounting for VAT on his sales, the tax lost is only that on his profit margin. If he imports the goods from outside the EU he similarly pays input VAT on his purchase price at the time of import. However goods acquired from another EU country enter the UK without a VAT charge being imposed either by the UK or the country from which the goods are imported. Instead it is up to the trader to account for VAT on the acquisition of the goods on his VAT return. At the same time he can normally claim that VAT as input tax so nothing is due to HMRC in respect of the goods until they are sold, when VAT becomes payable on the sale proceeds. Accordingly if the UK trader disappears without accounting for VAT it is the entire amount of VAT that he charges on his sale that is unaccounted for.

The UK’s derogation is limited to VAT on four specific types of goods. It has been granted for a limited period to 31 December 2009 only, in order to allow for an evaluation of its effectiveness (both as regards MTIC fraud and in preventing final consumption without VAT payment) and its impact on the functioning of the Internal Market. The Commission’s proposal to the Council to approve the UK derogation (COM/2006/555) indicates that it was accepted with reluctance and only on the basis that it applies only to a limited range of goods and because the UK told the Commission that it will affect only some 22,500 taxable persons out of a total of 1.9 million VAT registered businesses. The wider derogations sought by Germany and Austria were refused by the Commission. The UK derogation will cease to be effective if fraudsters move their attention to goods other than those in the four categories approved by the Commission. A broadening of the derogation to other categories seems unlikely to meet with the Commission’s approval.

MTIC fraud calls into question the efficacy of the system of allowing movements of goods free of VAT across borders between EU countries.

*What measures are currently applied in the UK?*

The UK has introduced a number of measures aimed to counter MTIC fraud.

1. Requirement of evidence or security (VATA 1994, Sch 11, para 4(2), inserted by FA 2003, s 17)
2. Joint and several liability (VATA 1994, s 77A inserted by FA 2003, s 18)
3. The reverse charge (VATA 1994, s 55A inserted by FA 2006, s 19)
4. Power to inspect goods (VATA 1994, Sch 11, para 10(2A) inserted by FA 2006, s 20)
5. Directions to keep records (VATA 1994, Sch 69B inserted by FA 2006, s 21)
6. The imposition of checks on the issue of VAT registration numbers.
7. HMRC have issued a leaflet, “How to spot VAT missing trader fraud”, which we believe was sent to all VAT registered traders.
The first two of these seek to impose liability for the missing trader’s tax on other traders in the supply chain. The weakness of this is that it is inherently unfair to impose on an innocent trader who becomes accidentally involved in an MTIC supply chain either an obligation to provide security for the tax of an unrelated third party as a condition of doing business, or a requirement to pay a tax liability of a third party with whom the trader may have had no dealings whatsoever.

HMRC have, of course, said that they will only impose an obligation to provide security on businesses which, despite warning, continue to deal with businesses that commit fraud. We have to date no experience of the imposition of such a requirement. It is hard to envisage how HMRC can effectively “warn” a business about another without breaching their duty of confidentiality unless the other’s involvement with a suspected fraud is in the public domain. HMRC have also said that they will not impose joint and several liability for another’s VAT debt on a trader unless he had reasonable grounds to suspect fraud. However the tests that HMRC expect a trader to carry out to escape liability go well beyond those that most traders would carry out as a matter of course. HMRC appear to believe that it should be obvious from the nature of the transactions that a person is becoming involved in an MTIC supply chain, but they may well underestimate the naivety of some traders.

These two measures effectively leave it to other traders to police MTIC fraud and to take the financial consequences of not doing so effectively. HMRC have set up a team who will check a supplier’s or customer’s VAT number if requested to do so by a trader. However they have said, “The team does not offer a service of approving transactions nor, if they confirm that the details provided are correct, can this be viewed as authorisation for the trader to do business with that VAT registration. Any decision to trade is a commercial decision for the individual business and Customs cannot tell businesses whether or not to undertake any specific transaction.” (Business Brief 15/03). This may be a resource issue. However this seems an odd policy in the context that a major problem with MTIC fraud is that the missing trader disappears before HMRC have pieced together the supply chain. Approving individual transactions would allow HMRC to monitor possible supply chains in real time, which would reduce that problem.

The reverse charge should prove effective in eliminating MTIC fraud in the commodities covered by it. However it seems likely that the fraudsters will in future use different types of goods not covered by the derogation.

The power to inspect goods and the duty to keep records ought to help HMRC in investigating a supply chain and thus facilitate prosecution of the criminals. However as the fraud will have preceded any such investigation they seem unlikely to have a deterrent effect. A series of successful prosecutions might have such an effect but prosecutions launched as a result of these powers are likely to take several years to come to court.

We do not know how effective pre-registration checks are. We suspect that HMRC do not know either. The fact that a person does not appeal against a refusal of a registration does not mean that he is a fraudster. We do know that the checks have brought about serious delays in the registration of new businesses, although we acknowledge that HMRC are taking steps to reduce such delays. Nevertheless there may be a balance to be sought between preventing fraud by a tiny number of people and deterring the establishment of new businesses in general by imposing a delay in registration—which to small businesses in particular often means a delay in being able to commence generating income. Such a delay can adversely affect the viability of the business.

Exhorting traders to apply checks on their suppliers and customers is unlikely to have much long-term effect.

The Commission Proposals on Co-operation

Better cross border liaison by tax and law enforcement authorities could well increase the likelihood of successful prosecutions. It seems unlikely to have much effect on preventing fraud occurring. It should also be noted that the Commission paper (COM/2006/254) itself notes at para 2.1: “Although the common legal framework for administrative co-operation was reinforced some years ago, the Member States do not make sufficient use of the new possibilities offered and the level of administrative co-operation is not commensurate with the size of intra-community trade.” The adequacy or otherwise of the mechanisms available become irrelevant if there is a reluctance to use them.
Are Member States capable of fighting MTIC individually?
We have no view.

Is it necessary to simplify or restructure the VAT system?
We believe that the only effective ways to counter the fraud are either to collect VAT when goods enter the UK from another EU country or to impose a reverse charge generally. Both of these would be fundamental changes to the VAT system.

Does the adoption of Community measures undermine Member States?
We have no views.

What would be the benefit and costs of moving from a destination to an origin system?
MTIC fraud on the current scale would not be possible under the origin system. VAT would be payable in the Member State of export when goods come into the UK so the opportunity to misappropriate VAT on the full price on an onward sale would no longer exist. However imposing VAT where goods are imported from another Member State would have the same effect. The origin system clearly has both advantages and disadvantages. We doubt that the existence of MTIC fraud ought to be the driver towards the replacement of the current destination system by an origin system.

15 January 2007

Memorandum by The Law Society

What impact does this fraud have on the Internal Market?
1. Fiscal fraud within the Community, depending on which statistics are taken, is said to siphon off billions of pounds and Euros from finance ministries. Missing Trader Intra Community (MTIC) fraud quite simply involves a “business” charging VAT and not accounting for the VAT to the tax authorities, usually but not invariably, followed by another business at a later stage in the supply chain making a claim for a VAT refund. It is perceived to have been facilitated by the changes made to the EU VAT system by the Single Market initiative in 1993.

VAT in overview
2. Value Added Tax (in the UK), and TVAs in other EU countries, involves a cascade system of taxes. They involve more taxpayers (most businesses, except those carrying on wholly VAT exempt businesses or those under the relevant registration threshold) as compared with sales taxes. For instance, purchase tax, replaced in 1973 by VAT in the UK, involved only retailers.

3. One advantage to tax authorities is that outputs or supplies made by A should tally with inputs or supplies received by B so that in principle the trader’s records should show if transactions are being suppressed ie not declared. Another advantage is that the VAT at stake is spread between several persons. An example may assist:
   A supplies assets to B for £100 and charges VAT of £17.50.
   B incorporates the assets into goods and sells the goods to C for £200 and charges VAT of £35.
   C, a retailer, sells the goods to the public for £250 and charges VAT of £43.75.
   The total VAT due is £43.75. However, A accounts for £17.50; B accounts for £17.50 (£35 received from C—£17.50 paid to A); and C accounts for £8.75 (£43.75 received from customers—£35 paid to B).
4. Other advantages of VAT include it covering not just goods but also services and accelerating, particularly in the case of retail sales, the time at which tax authorities collect the tax eg the £17.50 received from A long before C sells the goods to customers.
5. An important point to note is that if B decided to “run off” with the VAT collected from C the net cost to the tax authorities would be limited to £17.50 ie the difference between £35 received from C and £17.50 paid as input tax to A.
6. VAT becomes more complicated in an international economy. For exports outside the EU, it is important that local (eg UK) VAT is not charged as that could make goods uncompetitive in the export territory, either if no VAT is charged on supplies made in the country which imports the goods or local sales tax is charged, in addition, to any VAT borne in the exporting country. There would be little incentive for the importing country’s finance ministry giving credit for tax (eg UK VAT) paid in the exporting country as that would reduce the importing country’s tax base.

7. A similar issue arises for intra-Community trade. So, for instance, if the UK could charge VAT on goods exported to Germany and Germany could not charge local VAT on those goods, Germany’s tax base would reduce and the UK’s increase. (Admittedly the opposite would happen for supplies made to the UK by Germany, but whether Germany or UK would be net worse or better off would be difficult to predict, depending on decisions of individuals and companies). A possible solution to this would be for all VAT to be collected locally (“the origin system”), in this case the UK, and VAT receipts shared among EU countries by reference to formulae intended to take account of “export” and “import” patterns within the Union—the so-called “clearing house”. This has not found favour with Member States, not least because the formulae (assuming they could even be agreed) would be difficult to change to reflect altered trading patterns as Member States perceived reduced receipts coming into their exchequers.

8. There is also the problem that if VAT rates are different, eg the UK VAT rate is 17.5 per cent and German VAT is 20 per cent, an “importer” in Germany would pay lower VAT on UK goods than if they could buy identical German goods on which VAT of 20 per cent was charged.

9. So intra-Community trade in goods involves not charging local VAT in the “exporting” country and local VAT being charged on the “acquisition” of goods in the “importing” country. An important point, relevant to MTIC, is that all VAT charged on supplies made in the “exporting” country is rebated to the exporter. So, adopting the example in 2.4 above, if C “exported” the goods he would not have to account for any VAT (ie not account for £8.75) but in fact would be refunded £35.

10. Unlike a domestic supplier who is required to account for net VAT (ie taking account of input and output VAT), although an “importer” of goods who is required to pay VAT in relation to the “import” of goods into another Member State, that importer may not have paid that VAT to a supplier at the time he sells the goods. (He is, however, able to offset that VAT against output tax due on domestic sales.) However, if he sells goods at a price which includes VAT and then does not pay it over to the tax authorities he will disappear with a gross amount of output tax, not a net amount which takes account of VAT due on the “import”. Again, an example may assist.

G “imports” the goods from another Member State for £1 million (the vendor in the other Member State does not have to charge VAT).

G sells the goods to H for a suitably discounted price to make the goods attractive to H, say £900,000 charging VAT of £157,500.

G receives £1,057,500 and does not account for the VAT of £157,500 to HMRC. The net “profit” is £57,500.

H may then in turn sell on the goods to other traders who all make commercial profits ie only accounting for net amounts of VAT.

The position gets worse if, say, H is encouraged to sell goods to a person who “exports” the goods to another Member State as the exporter will be able to make a claim for input tax.

So, if I offered to buy the goods from H for £1m (and paid VAT of £175,000) to H:

H would account for net VAT of £17,500 (VAT received from I of £175,000—£157,500 paid to G).

I would reclaim as input tax £175,000.

The net effect is that HMRC has paid out in cash £175,000.

What are the measures currently applied in the UK and other Member States to combat this fraud and what are their weaknesses?

Courses of action taken in the UK

11. HMRC has tried to argue that transactions where any party in the supply chain was fraudulent were not “supplies” for VAT purposes. Accordingly, taxpayers could not claim input tax recovery. This was particularly relevant to an “exporter” which could as a result be denied recovery of VAT it had paid. Such an approach was found to be unlawful in Optigen (Cases C-354/03, C355/03 and C-484/03) if the taxpayers had no knowledge and no means of knowing that a previous supplier had been fraudulent.
12. HMRC have also sought to make taxpayers jointly and severally liable for tax unpaid by other suppliers and to strengthen the requirements for security (against non-payment of tax): sections 17 and 18 Finance Act 2003. Such legislation has been partly upheld before the ECJ: see R (on the application of the Federation of Technological Industries and others) v Customs and Excise Commissioners.

13. The use of joint and several liability to ensure self regulation of traders is overly burdensome. A constant difficulty is that the authorities expect traders to undertake line checks with their suppliers. Unfortunately the commercial realities of legitimate traders ensure that an individual has little opportunity to investigate his supply line beyond his immediate supplier and the entity to which he sells on. The one organisation that has the ability to take an overview of the entire transaction chain is HMRC. To place a liability on a taxpayer where they are participating in legitimate trade seems unfair and may have the effect of inhibiting honest trade.

14. Finance Act 2006 contains provisions which, subject to derogation being granted by Ecofin, would enable certain types of supply to be taxed differently. Returning to the example in 3:

A would sell goods to B for £100 on which B (not A) would account for the tax of £17.50 to HMRC. However, at the same time B would claim that the VAT of £17.50 was input tax and so B would not pay any amount to HMRC.

B would normally be liable for VAT of £35 on the goods it sold to C. Instead, B would only charge £200 and C would be liable to account for the VAT on the supply made by B to C (ie £35).

C assumed not to be supplying to other business customers, would charge VAT on its sales of £250, ie would collect £287.50 from its customers. C would claim that the £35 it was due to account for in respect of B’s sale to C constituted input tax and so C’s net liability was only on the £37.50.

15. The result is that all of the VAT is due at the end of the “supply chain”. In consequence there would be no VAT (if A were an “importer”) due from it which A could fail to account for. The liability would pass to B who, if B sold the goods onto C, would have no net liability. If C was an exporter then, instead of it being due a refund of VAT already paid to B, C would have no net liability but equally no entitlement to a refund. This is because the tax it would have been entitled to recover on the supply from B is due to be paid by C.

16. It will be apparent that this change to the VAT consequences of supplies of prescribed types of goods concentrates the risk of VAT not being paid in the end supplier eg where C sells to non-business consumers. It does not operate in the same way, at least as regards cashflows, as a cascade system.

17. The proposal is, however, different to a retail sales tax insofar as taxpayers throughout the supply chain would be required to maintain records of supplies in a broadly similar manner to the rules applicable to conventional transactions where the supplier accounts for VAT.

18. A concern for the taxpayers and their advisers is whether the types of goods subject to the modified rule will change rapidly by statutory instrument and so suppliers may not have time to modify their accounting software. Also the revised VAT accounting rules (ie where the purchaser accounts for the seller’s VAT) has important consequences for long-term commercial contracts, eg whether prices charged include VAT (if seller is responsible) or exclude VAT (if the buyer is due to account for the VAT on the seller’s supply).

Other Member States

19. It is understood that other Member States have different proposals to deal with MTIC fraud, many of which involve variations on the self-supply regime that HMRC wish to adopt.

The Commission has suggested measures including increased cross-border liaison by Tax and Law Enforcement Authorities and Governments, improved risk management, and mutual assistance by Member States wishing to recover unpaid taxes. Are these mechanisms adequate?

20. On the face of it increased cross border liaison ought to assist. Clearly where the same goods are moving in a carousel they ought to be picked up and potential identify fraudsters. The real issue is whether appropriate resources can be deployed by the relevant Member States, quite often at short notice, to deal adequately with fraudsters relatively adept at “covering their tracks”.

STOPPING THE CAROUSEL: MISSING TRADER FRAUD IN THE EU: EVIDENCE
Are Member States, within the context of the Internal Market and the Globalised Economy, capable of fighting individually against this fraud or is it right for the Commission to bring forward proposals on their behalf?

21. Clearly whether it is appropriate for the Commission to bring forward proposals depends on whether Member States are willing and capable to deal with an issue which, anecdotally, is said to affect some Member States more than others. Indeed it was reported that one reason for France not supporting the UK’s latest proposal (see 13 above) was a fear that more MTIC would occur in France and so affect French tax receipts (see 20 below).

Is it necessary to simplify or restructure the VAT System to prevent this type of fraud? If so, how might this be done?

22. It is understood that the Community is concerned about the integrity of the VAT system if widespread changes to the system are made, and certain Member States are said to be concerned that if the UK is given a derogation the carousel fraud will move to those Member States.

23. One possible way of dealing with the issue would be for VAT to be collected when goods enter a Member State, rather than “import VAT” accounted for in the taxpayer’s first VAT return. As the “importer” would have paid the “input VAT” he would effectively be in the same position as a local taxpayer as the VAT paid on importation would be tantamount to input tax. So the “importer” would be liable to account for only a net amount of VAT to the extent that, ignoring VAT, his selling price exceeded the “import” price.

24. This might be perceived to be a retrograde measure as regards the Single Market and could give rise to cashflow (ie “import VAT” funding) costs for importers. However, there seems to be no reason why funding to meet the VAT on importation costs could not be available to businesses in a variety of ways (not just commercial banks or factoring organisations). Consideration might be given to secure areas being used to store imported goods which did not require “import VAT” to be accounted for until the goods left the areas, so that the time between having to account for import VAT and expected VAT inclusive sales price was minimised. However, extension of the concept of “bonded warehouses” to many types of goods will necessarily give rise to some costs.

25. There is no perfect solution to the issue. Accordingly if decisions are to be taken at Community level, appropriate derogations are needed as an interim measure to protect the revenues of finance ministries. However, an obvious concern is that the fraudsters will simply move to a different product that does not attract the charge. Given the length of time it took to come close to agreement on the current proposals (which as we understand are still to come into effect) there is the prospect that enormous revenue could be lost whilst the inherent delay in agreeing further derogations takes place.

Does the adoption of measure to fight VAT fraud at the Community level undermine Member States’ control over the functioning of National Fiscal Systems?

26. We are not in a position to comment on this, which seems principally to be a political rather than a technical issue.

What would be the benefits and costs of moving from the current destination system to an origin system?

27. There would obviously be a need to re-programme or re-write computer software. Taxpayers and officials would need to be educated and appropriate publicity material prepared. There could be downward pressure on VAT rates as a customer in the UK faced with purchasing goods or services which (ignoring VAT) were equally priced from the UK attracting VAT at 17\(^\frac{1}{2}\) per cent or from a Member State charging lower or higher rates of VAT would take the VAT cost into account. This should not be over-stated as factors such as reliability of suppliers, currency risks, recourse to the supplier if goods or services are not delivered or are defective, etc will determine where orders are placed. Nevertheless, particularly for final consumers or those unable to recover VAT in full, differential VAT rates will be a factor which might reduce intra-community trade.

Who are the perpetrators?

28. One issue that is not addressed by the questions in the Call for Evidence is the common perception of the perpetrators of this fraud. The defendants to these cases do not often meet the public perception of “organised criminals”. Whilst enormous sums are lost through frauds of this nature, anecdotally it appears that some defendants are often “chancers” who happen to have identified an extremely lucrative means of defrauding
the tax payer. Specialist fraud practitioners who have experience of handling advising defendants in cases involving MTIC Fraud are not aware of any specific MTIC fraud whereby the proceeds of the offending are said to entered into either terrorism or of serious organised crime.

January 2007

Extracts from Attempt to measure cross border VAT fraud

Breakdown within the EU

OCS SPF Finances Belgique

I. INTRODUCTION

The goal of this work is to attempt to value the actual level of VAT fraud and its distribution within the Union. In fact, on the basis, of this same paper produced by the EC for the Council and the European Parliament, the Member States claim to be very concerned about the size and the recent trend of this phenomenon.

The majority of valuations carried out before now give more weight to the macroeconomic loss over the microeconomic. The results seem variable and not very convincing. Certain countries have attempted them; others not. What’s more, the calculations done at the European level do not take national disparities into account.

II. DEFINITIONS

When we speak of VAT fraud, what does that mean? First, a big distinction must be made between classic and organised VAT fraud. In its report on the “State of VAT fraud between the years 2000 to 2003.”¹, the OCS² precisely identified eight types of fraud linked to organised VAT fraud. These modus operandi are missing trader fraud, crossed billing, false intra-company deliveries, false exports, abuses of the margin framework, false invoices, in and outers, and buffer companies.

The most important in terms of damage is cross border fraud (MTIC or carousel fraud with the help of defaulting operators) . . .

Classic fraud is more diffuse: it means a loss of earnings for the state, from reasons as diverse as the underground economy, tax evasion, abuse of deductions, “intentional” errors, non-payment, . . .

Carousel fraud is not new. A trace of it can be seen in the mini-market unique to Benelux in the beginning of the 1980s but the real level of the amounts involved and their number are making for some worrying files at the moment. Carousel-type VAT fraud is notable in that it is closer to swindling than to true tax fraud. What’s more, the level of this fraud is theoretically limitless. This point will be explored further in Section 2.

The breakdown between classic fraud and organized fraud is a big unknown without any reliable estimates as to their sizes. The OCS estimated organized VAT fraud in Belgium for the year 2001 at 1.1 billion Euros and for the same year, classic VAT fraud at 2 billion Euros³ which gives us a 1/3–2/3 ratio in 2001; organized fraud decreased to 159 million Euros in 2005. The ratio was thus 1/13–12/13. The proportion between the two amounts can therefore vary enormously.

One will have understood that organized VAT fraud and in particular carousel fraud, occupy a unique position at the heart of VAT fraud.

Between 2001 and 2005, Belgium successfully implemented a policy against carousel-type fraud. The significant volume of carousel cases is such that a coordinated action against the players has had the effect of shattering the breakdown between classic and organised fraud. It is now clear that in certain cases organised fraud plays an important role in the total structure of fraud and that the situation can vary enormously in a short space of time. The control of one or the other phenomenon is going to change the balance of power and have an immense impact in terms of loss. The situation is very different for classic fraud.

The goal of this work is indeed to try to measure the impact of organised fraud within total VAT fraud and more precisely on MTIC intra-Community transactions which are a component of it, made possible due to the introduction of the transitory regime in January 1993.

² The OCS is a multidisciplinary unit specializing in the fight against organized VAT fraud.
³ By extrapolation of fiscal checks.
The work is divided into three large sections, the first will encompass the definitions and descriptions necessary for a good understanding of the operating modes of MTIC fraud. The following section will dwell on the different approaches possible to tackle the study and estimate of VAT losses. The third and last section will utilise the data contained in the EUROCANET network to evaluate the level and distribution of MTIC fraud within the European Union. The conclusion will draw up a summary table of the existing valuations.

We can see the difference between a classic fiscal fraud and organized VAT fraud whose mechanism is like swindling through an abuse of the system. In summary, a country will potentially be at greater risk the bigger its market and the larger its VAT refunds. It will have a low risk if it has a small domestic market and low levels of VAT refunds. We will see in the chapter on estimates where each of the EU countries fit within this profile.

III. Estimates

III.1 The macroeconomic approach

The macroeconomic approach is the one most often found in the literature. The main reason for this is easier access to the source data for the estimates. However, they (the estimates) have disadvantages in terms of accuracy and timing.

GDP

The size of the country and the size of the domestic markets were able to have an influence on the risk of VAT fraud. We show now the GDP of the 25 member countries of the EU.

Five countries alone account for 3/4 of the EU’s GDP: Germany, the UK, France, Italy and Spain. On first glance, these countries, each with large domestic markets, should be the most exposed to the risk of type 1 fraud, that is to say, the case where fraudsters sell their goods on national markets and receive the VAT from their customers. At the bottom of the list, eleven countries comprise just 3 per cent of the total wealth. This cluster of small countries has less risk given the narrowness of their markets and is less attractive to criminal organizations. We will clearly see that big disparities exist between Member States.

Table of 25 Member countries’ GDP for the year 2004, and cumulative for the year 2004, also in percentages:

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP 2004</th>
<th>Cumulative GDP 2004</th>
<th>% EU</th>
<th>Cumulative %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>2,740,551,000,000</td>
<td>2,740,551,000,000</td>
<td>21.4</td>
<td>21.1</td>
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<td>United Kingdom</td>
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<td>4,864,936,000,000</td>
<td>16.6</td>
<td>36.0</td>
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<tr>
<td>France</td>
<td>2,046,646,000,000</td>
<td>6,911,582,000,000</td>
<td>16.0</td>
<td>54.0</td>
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<td>Italy</td>
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<td>6,589,416,000,000</td>
<td>13.1</td>
<td>67.1</td>
</tr>
<tr>
<td>Spain</td>
<td>1,039,927,000,000</td>
<td>9,629,343,000,000</td>
<td>6.1</td>
<td>75.2</td>
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<tr>
<td>Netherlands</td>
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<td>Belgium</td>
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<td>10,560,634,300,000</td>
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<td>Sweden</td>
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<td>10,907,048,700,000</td>
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<td>85.2</td>
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<tr>
<td>Austria</td>
<td>292,327,800,000</td>
<td>11,199,374,500,000</td>
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<td>Poland</td>
<td>242,292,600,000</td>
<td>11,441,667,100,000</td>
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<td>Denmark</td>
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<td>Greece</td>
<td>205,215,400,000</td>
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<td>Finland</td>
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<td>Czech Republic</td>
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<td>Hungary</td>
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<td>0.8</td>
<td>98.6</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>41,093,970,000</td>
<td>12,672,374,770,000</td>
<td>0.3</td>
<td>99.0</td>
</tr>
<tr>
<td>Slovenia</td>
<td>32,181,750,000</td>
<td>12,704,556,520,000</td>
<td>0.3</td>
<td>99.2</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>31,864,290,000</td>
<td>12,736,420,810,000</td>
<td>0.2</td>
<td>99.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>22,262,690,000</td>
<td>12,758,683,500,000</td>
<td>0.2</td>
<td>99.6</td>
</tr>
<tr>
<td>Cyprus</td>
<td>15,418,350,000</td>
<td>12,774,101,850,000</td>
<td>0.1</td>
<td>99.8</td>
</tr>
<tr>
<td>Latvia</td>
<td>13,571,250,000</td>
<td>12,787,673,100,000</td>
<td>0.1</td>
<td>99.9</td>
</tr>
<tr>
<td>Estonia</td>
<td>11,238,550,000</td>
<td>12,798,911,650,000</td>
<td>0.1</td>
<td>100</td>
</tr>
<tr>
<td>Malta</td>
<td>5,319,674,000</td>
<td>12,804,231,324,000</td>
<td>0.0</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: World Bank
We will later see, with the help of other indices, if the large countries are in fact the most affected by fraud.

The “technology” coefficient summarized in the table below shows the importance of the electronic market in each country. It is calculated on the basis of mobile telephone and PC purchases by head of population. The same trends emerge: a big difference between small and large countries. Given that we know fraudsters have a predilection for these business sectors, this supports the hypothesis of a larger risk in these countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>Technology Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>119.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>97</td>
</tr>
<tr>
<td>Italy</td>
<td>89.7</td>
</tr>
<tr>
<td>France</td>
<td>77.5</td>
</tr>
<tr>
<td>Spain</td>
<td>52.3</td>
</tr>
<tr>
<td>Poland</td>
<td>36.6</td>
</tr>
<tr>
<td>Netherlands</td>
<td>29.6</td>
</tr>
<tr>
<td>Sweden</td>
<td>15.3</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>14</td>
</tr>
<tr>
<td>Belgium</td>
<td>13.1</td>
</tr>
<tr>
<td>Austria</td>
<td>12.9</td>
</tr>
<tr>
<td>Portugal</td>
<td>12.8</td>
</tr>
<tr>
<td>Greece</td>
<td>11</td>
</tr>
<tr>
<td>Hungary</td>
<td>10.8</td>
</tr>
<tr>
<td>Denmark</td>
<td>9</td>
</tr>
<tr>
<td>Finland</td>
<td>7.7</td>
</tr>
<tr>
<td>Ireland</td>
<td>6.2</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>6.1</td>
</tr>
<tr>
<td>Lithuania</td>
<td>4.9</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2.5</td>
</tr>
<tr>
<td>Latvia</td>
<td>2.4</td>
</tr>
<tr>
<td>Estonia</td>
<td>2.1</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>0.9</td>
</tr>
<tr>
<td>Malta</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: WTI

VAT Refunds

If the size of the country has a large influence on the amount of fraud, the level of VAT refunds also obviously increases this risk, in particular for MTIC fraud. Let’s look at the following table which shows the level of these refunds:

<table>
<thead>
<tr>
<th>Country</th>
<th>VAT refunds (Euro billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>75.93</td>
</tr>
<tr>
<td>France</td>
<td>34.19</td>
</tr>
<tr>
<td>Spain</td>
<td>19.8</td>
</tr>
<tr>
<td>Sweden</td>
<td>17.3</td>
</tr>
<tr>
<td>Poland</td>
<td>10.2672</td>
</tr>
<tr>
<td>Belgium</td>
<td>7.5</td>
</tr>
<tr>
<td>Portugal</td>
<td>3.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>2.92</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>2.4648</td>
</tr>
<tr>
<td>Greece</td>
<td>1.24</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>0.84</td>
</tr>
<tr>
<td>Lithuania</td>
<td>0.73</td>
</tr>
</tbody>
</table>

Source: Annual reports of national fiscal authorities
The United Kingdom is way ahead of the other Member States, followed by France and Spain. More astonishing is Sweden just behind, hotly pursued by Poland. However, in order to take into account the “exporter” nature of the country, the refunds must be corrected by a coefficient for this factor. In fact, refunds are very strongly correlated to whether or not (legitimate) exports are significant in size.

Up until now, we have looked at refunds in terms of their nominal value. If we compare them in proportion to net VAT receipts, the results differ a little. The United Kingdom is still ahead with a rate of almost 55 per cent followed by Spain. By contrast, the Slovak Republic, Poland and Sweden have an equally high rate.

By grouping together the two variables (refunds and electronics market) into the same coefficient, we have a clear picture of the risk for each country.

<table>
<thead>
<tr>
<th>Country</th>
<th>K-risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>172.93</td>
</tr>
<tr>
<td>France</td>
<td>111.69</td>
</tr>
<tr>
<td>Spain</td>
<td>71.90</td>
</tr>
<tr>
<td>Sweden</td>
<td>32.60</td>
</tr>
<tr>
<td>Poland</td>
<td>46.87</td>
</tr>
<tr>
<td>Belgium</td>
<td>20.60</td>
</tr>
<tr>
<td>Portugal</td>
<td>16.10</td>
</tr>
<tr>
<td>Ireland</td>
<td>9.12</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>8.58</td>
</tr>
<tr>
<td>Greece</td>
<td>12.24</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>1.74</td>
</tr>
<tr>
<td>Lithuania</td>
<td>5.63</td>
</tr>
</tbody>
</table>

Source: VAT refunds: Annual reports from the national fiscal authorities Electronics market: WTI

The Level of Intra-Community Deliveries

The total value of tax exempt goods circulating in the EU is currently growing by 1,800 billion Euros each year, representing some 210 billion Euros of VAT. A good number of these exemptions are justified, but by assuming 10 per cent are fraudulent transactions, we get 21 billion Euros of potential MTIC fraud.

The Belgian situation is as follows: Belgium acquired 20 billion Euros of tax exemptions in 2004 for 150 billion Euros of goods in other Member States. That is to say, the loss for 2001, before the action plan against carousels, has been estimated at 1.1 billion Euros, equivalent to 5.1 per cent of the intra-community purchases made by the country. This coefficient of 5.1 per cent applied to the intra-community purchases across the Union would give a loss of 10.7 billion Euros for Europe.

Calculation of the VAT Gap (British Model)

Since 2002, the British customs administration has developed a valuation method for VAT losses, which relies on the calculation of a VAT gap which attempts to measure the revenue loss to the Treasury.

The calculation takes place in two steps. The first tries to estimate the theoretical level of receipts if there were no loss. This level is called the VAT theoretical tax liability (VTTL), and is calculated on the basis of the following elements:

— The national accounts and more accurately, the level of expenses subject to tax;
— The estimate of VAT due on these goods;
— The legitimate deduction of certain duties (like, for example, tobacco).

The second step consists of subtracting from the VTTL the actual receipts in the fiscal year concerned. The remaining amount is assumed to be lost VAT for whatever reason (fraud, tax evasion, error).

III.2 Microeconomic approach

In contrast with the macroeconomic approach, this technique uses the disaggregated data. Access to the data is more difficult because only the tax administrations have them to hand, but, to its advantage, in a rather short time delay. By contrast, this technique requires greater knowledge of business, domestic economics and fraud expertise, in particular so that technical problems, errors and obvious fraud can be excluded. The data
used come from international administrative cooperation efforts such as for example the VIES system. The most frequently used method is what is known as mirror flows. Currently another technique is also being used: profiling. The source data are therefore those from international databases of VAT declarations.

In the two cases (mirror flows and profiling) we work on the individual data which are then summed up or extrapolated to arrive at the desired estimate.

**Mirror flows**

The mirror flow method is in fact a data cross. By breaking down the diagram describing the intra-community delivery/purchase (ICD-ICP), we can better understand this method.

[Diagram between member states 1 and 2 showing the delivery is the same as the purchase and is reported via VIES quarterly]

On each side of the border, Member State 1 and Member State 2 have concrete information. The matching of this information will point out fraudulent transactions in Member State 2 (via missing trader). Border hopping is made possible by cooperative administrations and more generally by the VIES automated network. The matching of data furnished by Member State 1 and national data present (or absent) in VAT declarations provides evidence of fraud. On one side we learn that MTT carries out some intra-community purchases in Member State 1 for significant amounts, and at the same time it is at fault for not filing VAT declarations in its own country.

**Profiling**

As for profiling, the technique is the same. The profiles are detected individually by the models, then aggregated in order to assess the weight of each fraud profile.

**The Belgian method**

The development of this organized VAT fraud valuation method stems from the implementation of automated VAT carousel detection techniques by a carousel unit of the OCS. The method is simple and relies on the reasoning explained hereafter.

In summary our technique consists of calculating a ratio of total fraud to known fraud at any given moment. A big advantage in terms of organized VAT fraud is due to the fact *a posteriori* that the exact amount of fraud can be determined\(^4\) for several of the operating modes and particularly in the case of defaulting operators (MTIC) and crossed billing. What’s more, these two modes alone account for more than 50 per cent of the organized VAT fraud, and it’s thanks to this unique ability to be specific that estimation is possible. Such an opportunity does not exist for neither classic VAT fraud nor for direct taxes.

**The Commission Census**

During the second half of the 1990s, the EC carried out a census of intra-community fraud in the 15 countries of the Union. The result was a little skinny: 299 cases uncovered for a value of 500 million Euros. This figure is well below estimates and opinions. Either the selection criteria were too strict, or the Member States were a little afraid to state their problems or the most likely, they couldn’t count cases that they had not yet detected themselves. Whatever the reason, the result was far from an accurate reflection of the very serious situation at the time.

\(^4\) After four months for defaulters and after one month for crossed bills.
III.3 EUROCANET

Eurocanet⁵ is an information exchange network based on international administrative cooperation as stipulated in Rule 1798/2003. The lowest level statistics used regroup the available data from 2005–06 for a total amount in excess of 13 billion Euros of deliveries, equivalent to 2.7 billion Euros of potential VAT fraud. It would appear from analyses done by the OCS that more than 95 per cent of intra-community deliveries recorded in the network are fraudulent.

It turns out that one type of fraud falsifies these findings. The OCS could extract this data corruption which accounts for a non-negligible share of the transactions: the Dubai⁶ route. This type of fraud is committed with the damage occurring exclusively to the UK. It involves deliveries for very significant sums. We also notice that this fraud only shows up in the first three deciles of the data (that is to say in 30 per cent of gross transactions).

**COMPLETE DISTRIBUTION OF NETWORK DATA**

By considering as a hypothesis⁷ an amount of 14.8 billion Euros for annual classic carousel fraud (therefore without the Dubai route), we obtain the following results:

<table>
<thead>
<tr>
<th>Country</th>
<th>Breakdown (w/o Dubai)</th>
<th>15 billion Euros for the EU</th>
</tr>
</thead>
<tbody>
<tr>
<td>GB</td>
<td>25.4%</td>
<td>3,756,464,827</td>
</tr>
<tr>
<td>ES</td>
<td>17.3</td>
<td>2,583,335,071</td>
</tr>
<tr>
<td>IT</td>
<td>15.7</td>
<td>2,324,173,825</td>
</tr>
<tr>
<td>DE</td>
<td>13.2</td>
<td>1,953,740,782</td>
</tr>
<tr>
<td>FR</td>
<td>10.2</td>
<td>1,515,000,000</td>
</tr>
<tr>
<td>NL</td>
<td>4.6</td>
<td>680,001,613</td>
</tr>
<tr>
<td>DK</td>
<td>3.0</td>
<td>445,428,207</td>
</tr>
<tr>
<td>BE</td>
<td>1.5</td>
<td>221,483,000</td>
</tr>
<tr>
<td>PT</td>
<td>2.4</td>
<td>361,934,897</td>
</tr>
<tr>
<td>LU</td>
<td>1.4</td>
<td>203,865,264</td>
</tr>
<tr>
<td>AT</td>
<td>1.0</td>
<td>143,771,179</td>
</tr>
<tr>
<td>IE</td>
<td>0.8</td>
<td>120,205,178</td>
</tr>
<tr>
<td>CY</td>
<td>0.7</td>
<td>105,901,856</td>
</tr>
<tr>
<td>PL</td>
<td>0.7</td>
<td>102,889,729</td>
</tr>
<tr>
<td>SE</td>
<td>0.6</td>
<td>90,101,126</td>
</tr>
<tr>
<td>EL</td>
<td>0.4</td>
<td>66,485,645</td>
</tr>
<tr>
<td>CZ</td>
<td>0.3</td>
<td>45,943,138</td>
</tr>
<tr>
<td>SK</td>
<td>0.3</td>
<td>33,641,868</td>
</tr>
<tr>
<td>MT</td>
<td>0.3</td>
<td>25,392,354</td>
</tr>
<tr>
<td>EE</td>
<td>0.3</td>
<td>22,483,286</td>
</tr>
<tr>
<td>OTHERS</td>
<td>0.1</td>
<td>17,757,355</td>
</tr>
<tr>
<td></td>
<td>100.00%</td>
<td>14,800,000,000</td>
</tr>
</tbody>
</table>

Source: Aggregate data from Eurocanet

In the network, the total fraud for the UK breaks down between:

- 30 per cent for classic carousel.
- 70 per cent for Dubai route.

As for damages from the Dubai route, used exclusively with goods from the electronics sector, we can establish an 8.85 billion⁸ Euro loss to the British Treasury.

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⁵ Stands for European Carousel Network.
⁶ By Dubai route, we mean fraud involving a third country in the billing chain, which in 90 per cent of cases is Dubai, but also Hong Kong, Switzerland, the USA or other emirate states.
⁷ Arithmetic average of our four results obtained by the macro approach: 21 (10 per cent intra-community deliveries), 10.7 (5.1 per cent intra-community deliveries), 11.45 (UK method extrapolated to the EU on the basis of GDP), 16 (mirror flows for the EU).
⁸ 15 billion x 27 per cent (electronics share) x 68.6/31.4 = 8.85 billion.
The result gives a breakdown which appeared completely valid, especially if we compare it to the macroeconomic criteria submitted as evidence in the section devoted to that approach (GDP, refunds . . .). Nonetheless, in view of the results, the hypothesis of 14.8 billion Euros must be treated as a “Upper limit” valuation.

IV. CONCLUSION

For the first time in this type of analysis, we have used microeconomic data for all of the Union. This reinforces the accuracy of our results on the relative breakdown of MTIC fraud at the heart of the Union. We can say these results are credible thanks to the cross checks with national studies to which we had access. A first observation is imperative: the inequality in the breakdown at the community level; one country accounts for 50 per cent of the fraud and five countries suffer 85 per cent of the total. By contrast, the results in absolute terms (a total of 24 billion Euros) are much lower than recently cited figures of 50–60 billion. Even if our study is only treated as an upper limit estimate, these are important. What is especially worrying is the parallel between the results of the Eurocanet breakdown and the distribution of national wealth (See the graph of GDP), even though the network is only quasi-exclusively reporting fraudulent flows. This would indicate a strong correlation between potential risk and known fraud.

We must note as well that the Dubai route itself is a significant problem which must be treated with the closest attention given the enormous amounts at play in the UK.

The size of the country as well as repayment policies and the clampdown measures implemented strongly influence the level of fraud. As a function of these factors, it is interesting to note that MTIC fraud can vary significantly from year to year. Fraud is going to gorge itself on the weaknesses of the system as soon as it identifies them, thus creating a snowball effect and an exponential growth in losses to the States.

In the future, the solution for a damage estimate will be the development of an accurate valuation tool for fraud, one single model implemented at national level, working on national data, which will then allow relevant comparisons between States.

August 2006

Memorandum by OLAF

A. THE ROLE OF THE EUROPEAN ANTI-FRAUD OFFICE IN THE FIGHT AGAINST VAT FRAUD

1. The Commission’s Anti-Fraud Office (OLAF) is responsible for the protection of the financial interests of the Community together with the competent authorities of the European Member States (see Article 280 EC Treaty). In the area of VAT OLAF has no investigative powers of its own. The Office therefore acts as a service platform to assist and co-ordinate the operational anti-fraud activities of the Member States at their request.

2. The Office dedicates a limited amount of resources to assist the Member States to combat international VAT fraud. It has over 10 years’ experience in working with the investigative and prosecution authorities of the Member States and targets its available resources to combat specific cases of large-scale VAT fraud where more than two Member States are affected.

3. The particular added value of OLAF consists in its specific multi-functional and multi-disciplinary structure which allows it to provide operational and intelligence anti-fraud assistance in an international environment, cooperating with partners in the Member States as well as in third countries. OLAF is able to gather information from and exchange it with its partners, obtain it from its own sources, arrange coordination meetings at which investigators and representatives from the judicial authorities are able to exchange case-related information openly and decide on future actions, and even finance meetings and missions in other countries in order to gather evidence. OLAF cannot, and does not attempt, to direct the actions of the Member States.

B. COMMENTS IN REPLY TO THE QUESTIONSPOSED BY THE SUB-COMMITTEE

Q1. THE IMPACT OF VAT FRAUD ON THE INTERNAL MARKET

4. Cross border (intra-Community)/transnational VAT fraud does not only affect the financial interests of the Member States and of the European Community but also has an impact on honest businesses which find themselves unable to compete on a level playing field in those sectors which are affected by a significant amount of VAT fraud.
5. Missing Trader VAT fraud (MTIC fraud) is a form of organised tax fraud carried out by organised criminals who put in place a structure of linked companies and persons. The fraud schemes are based either on virtual or real carousel transactions (where the same “goods” are sold and resold several times). In the latter case large numbers of goods (eg mobile phones) are sold on the market at a price significantly below the normal market price (because the fraudsters profit from the VAT which they collect but fail to pass over to the fiscal authorities). Moreover, the profits from VAT fraud may finance other types of fraud, for example cigarette smuggling or drugs trafficking, which has a further negative impact on the Community and national budgets, on the operation of the internal market and on honest businesses.

Q2. Counter measures in the Member States and their weaknesses

6. The exact description of national counter measures to international VAT fraud which the Member States apply can only be given by the national authorities. The measures adopted to combat the fraud can be of an administrative as well as of a judicial/enforcement nature. OLAF’s practical experience has shown that early cooperation among all relevant authorities can be decisive for successful anti-fraud work. The use of financial information as an element of tax investigations can be very helpful. However, there are considerable differences in the approaches chosen by the Member States ranging from a very close cooperation between the various national authorities (or even tax investigation services which themselves have quasi-police powers) to a relatively strict separation between administrative and judicial activities.

7. Moreover, cross-border cooperation between Member States is of particular importance in tackling international VAT fraud. Regulation (EC) 1798/2003 provides the framework for administrative cooperation between Member States’ tax authorities. This covers general administrative cooperation as well as cooperation with a focus on combating VAT fraud, but without any operational or intelligence support from the Commission (OLAF). This regulation also provides for a VAT Information Exchange System (VIES) through which Member States exchange information on intra-Community supplies of goods.

8. Intra-Community Missing Trader VAT Fraud is, by definition, not limited to any single Member State. It cannot be tackled by any Member State acting alone because each Member State sees only that part of the picture which occurs in its own national territory. Only through close cooperation and regular but targeted exchanges of information can Member States expect to have sufficient data to combat the fraud. Information exchanged under the VAT Information Exchange System (VIES) makes a contribution to this objective, but it is not a mechanism for exchanging fraud information in real time, and the information which it contains is often available too late to enable the fraudsters to be identified while the fraud is continuing.

9. The local tax authority has the most information about a company. Quick, direct contact between the competent local tax authorities for the exchange of case-related information is a key to combat the fraud. The tax authorities are working at national level to improve the situation. The installation of anti-fraud mail boxes and central anti-fraud units at national level speed up the international communication, but it seems that not all Member States are progressing in the same way. There is still much to do.

10. The Commission has no legal power to initiate modifications in the work plans and methods of the Member States to combat cross border VAT fraud. OLAF proposes, facilitates and stands ready to coordinate multi-national action to combat specific frauds. Although individual investigators and Prosecutors are often ready to cooperate with OLAF in specific cases (normally when they can see an advantage to be gained for their case), there is very strong resistance at a policy level in several Member States, including the United Kingdom, to having anything to do with OLAF. The UK refuses to work with OLAF in VAT cases because they believe that there is no Community competence in the VAT area. It seems that they fear that the Commission will use any cooperation with OLAF as a way of extending the Commission’s competence and influence in this area.

Q3. The Commission’s proposal—Mutual administrative assistance

11. Some Member States argue that current Community VAT legislation does not provide any basis for the exchange of operational fraud information, and that this is the reason why they cannot cooperate with OLAF. This seems a convenient excuse. The Commission has, nevertheless, presented a legislative proposal on mutual administrative assistance in the fight against EC fraud, inter alia also against cross-border VAT fraud in order to put beyond doubt that such information can be exchanged, but several Member States—the United Kingdom being one of the leaders are resisting this proposal very strongly. The proposal for a Regulation on mutual administrative assistance (COM (2006) 473), which is currently under negotiation in the Council anti-fraud working group, provides for support and assistance from the European Commission (OLAF) to the Member States in different areas, including VAT fraud. It will give a more detailed legal framework for the role
of the Commission (OLAF) as a facilitator and a provider of services to the Member States. Member States’ investigation services could profit from a European infrastructure, which is not driven by singular national interests, providing for a multi-disciplinary cooperation and coordination support, providing for the use of financial information from the anti-money laundering sector (Financial Intelligence Units) and assuring also the interface between administrative assistance and judicial follow-up. Tax authorities could very much profit from it as it does not follow an approach of pure tax cooperation but, in contrast, is a multidisciplinary anti-fraud approach.

12. Based on the principle of subsidiarity the Regulation’s VAT provisions would apply only in cases of particular interest at Community level, ie more than 500,000 Euro tax damage and at least two Member States involved. It does not confer on the Commission (OLAF) any investigation or powers of direction towards the Member States’ authorities. It complements the cooperation between Member States under Regulation (EC) 1798/2003, without replacing it, in those important cases where bi-lateral and multi-lateral tax cooperation is not sufficient and needs to be stepped up by a more intensive anti-fraud cooperation.

Q4. Can Member States fight VAT fraud on their own

13. No single Member State is capable of fighting this fraud alone. Its global nature means that the Member States and third countries must cooperate closely to tackle the fraud. OLAF’s objective in the VAT area is to supply a service to the Member States to facilitate contacts, cooperation and exchange of information. OLAF sees more of the “big picture” than an individual Member State, and can make more pieces of the puzzle available to the Member States. OLAF can put the relevant authorities into contact with each other, and arrange for coordination meetings to take place with a view to the Member States deciding on coordinated actions to tackle the frauds. OLAF does not have the desire, the legal base or the resources to take over any investigation, but simply wishes to make its knowledge and facilities available. By refusing to take this assistance the Member States are depriving themselves of a tool which would be helpful to them in fighting international VAT fraud. This is a short-sighted policy which causes unnecessary damage to the Member States, their taxpayers and the Internal Market.

Q5. Necessity to change the VAT system to prevent fraud

14. Any ideas for possible changes to the current VAT system would have to be examined in advance to determine their likely impact on the types and level of fraud which could ensue in order to determine whether the changes would produce a net benefit.

Q6. Fighting VAT fraud at Community level undermines Member State control over the functioning of national fiscal systems

15. The VAT system in the Member States is in fact the Community harmonised system. Therefore, it seems a reasonable starting point that solutions for fighting frauds which exploit this system should also be found at a Community level. Moreover, since the most damaging VAT fraud takes place at an international rather than a national level, it is at least arguable that measures should be taken at an international level to combat such fraud. Such measures could take many forms. However, from OLAF’s perspective, the most effective measures would be the real time exchange of relevant anti-fraud information between the Member States and with the Commission so that analyses could be made to enable a better targeting of resources on fraudsters before significant damage has been caused to VAT receipts. In addition, the exchange of information to tackle ongoing frauds would ensure that all relevant authorities had the full picture, and action could be coordinated to ensure that the fraud was tackled in the most effective way, at the best time, and in the appropriate jurisdictions.

16. This would not mean that national measures would become irrelevant. Indeed, the results of national control measures would feed into international actions which, in turn, would produce benefits at a national level. Effective national controls would still be a key to successful international anti-fraud efforts. But some international cooperation and coordinated action in specific cases is essential to protect national revenues. This means that national resource allocation will have to take this factor into account. Difficult choices may sometimes have to be made, but it is important that sufficient resources can be available to contribute to tackling frauds which impact on several or all Member States.

17. OLAF would certainly not wish, or be in a position, to direct national control policies or fiscal systems. But in cases of major fraud at Community level OLAF would play its role of facilitator and coordinator and would expect all Member States to play their part in ensuring that there are no “information gaps” or other
problems which mean that important cases in other Member States cannot be pursued because of a lack of will or because of administrative or procedural problems. At the present time, OLAF has not committed many resources to the VAT area since it is clear that several Member States, including the UK, simply do not want OLAF involved in helping to fight international VAT fraud. If this attitude were to change, then the resources allocated to fighting VAT fraud could be reassessed.

Q7. Benefits of a shift to the origin system

18. This question raises matters of tax policy and not of specific anti-fraud policy, and therefore falls outside the competence of OLAF.

19 January 2007

Memorandum by Olympia Technology Limited

I feel it is extremely significant that the Select Committee obtain facts from an Entrepreneur in the Telecoms sector. A coin has two sides and I believe it is only appropriate that I be given a chance to give at least a version of events which are currently surrounding the mobile phone industry.

Factual Background

— Olympia Technology Ltd (OTL) was incorporated in July 2000.
— Since its incorporation it has traded in Telecommunications Equipment.
— Olympia Technology Ltd (OTL) has rendered its VAT returns on monthly basis.
— OTL claim for input tax with respect to the period 2004–06 and 2005–06 has been subject to an “Extended Verification” by HMRC for the period of nine months.
— OTL has always demonstrated it takes all necessary precautions and carries out all relevant due diligence checks to protect the company and this demonstrates OTL’s stability and care in being caught up MTIC fraud.
— OTL has always proved not to be reckless or careless in conducting its business or transactions by submitting the commissioners with “All relevant documents” in order to assist the commissioners in verifying its repayments. This includes all Invoices, Batch numbers of all mobile phones purchased, all inspection reports.
— All OTLs suppliers and customers are vetted thoroughly to ensure that the supplier and Customer concerned was an established business, was properly registered for VAT, and that its directors could all be identified.
— A thorough examination is carried out by an independent company of all goods purchased in order to ensure that the goods were as stated on the invoice of the supplier concerned.
— OTL notifies the Commissioners Redhill VAT Office by fax prior to each and every transaction taking place, providing details of relevant supplier, customer and location of the mobile phones in which it is dealing.
— OTL scans and records the IMEI (Batch Numbers) of all handsets it purchases and stores them on a database which is used to ascertain whether any handset it subsequently purchases has not been purchased previously. OTL adapted this procedure before it was compulsory for the mobile telephone wholesalers in July 2006.
— OTL provided to its local VAT officer on a monthly basis all details of the transactions it undertook, including IMEI numbers of all mobile telephone handsets it traded in.
— OTL privately insured all shipments of goods made to its customers on CIF basis.

The Commissioners refused to give any indication as to when the verification exercise they are conducting would be completed.

Back in 2004, OTL sent a due diligence presentation to HMRC department and Regional Co-ordinator for London area, to make HMRC aware of the checks which OTL perform before and after the transactions.

The Extended Verification has left an enormous financial impact on OTL, thus we welcome the verification conducted by HMRC department, it is my opinion that HMRC should be able to differentiate between good and bad and carry out verifications in an appropriate and proportionate manner allowing the honest tax payer to be able to continue trading legitimately.
Attacking an honest taxpayer, innocent trader of disrupting business is not a long-term solution to combat MTIC fraud, as this would shift the burden on the UK courts to take a different view or approach.

Obtaining an individual derogation is not a sustainable solution in the long-term, what HMRC need to do is the following and these are only my suggestions.

1. HMRC should be able to differentiate between good and bad.
2. HMRC should design and implement their own system, where traders or business can conduct credit checks or identity checks. Checks that will identify good from bad, rather than depending on third party information.
3. Re-introduce Memorandum of Understanding in the Telecoms sector, and enforcing new stronger measures and guidelines.
4. Design and implement stronger procedures for Freight forwarders, who are responsible for the shipments of mobile phones.
5. Appoint an individual company who will inspect goods and scan goods on behalf of HMRC.
6. An individual company appointed by HMRC should scan all IMEI numbers (Batch Numbers), and forward it to HMRC prior to any shipments leaving the UK or coming into the UK.
7. HMRC should maintain full control over the batch numbers thus enabling them to check and authenticate the IMEI numbers by confirming whether they are genuine or whether they have been circulated prior to a company buying or selling it. Leaving the commercial decision to be taken by the taxpayer.
8. A limit should be placed on the size of a transaction at any one time executed by the trader.
9. Extended verifications should be conducted expediently and proportionately.
10. Transactions which are in a chain and represent more than three or five people should not be authorised or conducted unless the taxpayer, supplier and customers can demonstrate all those in the chain are identifiable, registered for VAT purposes under the trade classification of “Telecoms”, and conducting business for more than one year and all information possessed by HMRC on their system match the ones sent by the trader.

In the Select Committee on Economic Affairs Sixth Report paragraph 219(d) states “We therefore recommend that future consideration should be given to the proposition that the supplier should be given a right to appeal to the courts on a ‘Reasonable excuse basis’.”

In OTL’s verification it took eight months for the commissioners to conduct verification and nine months to reach a decision whether to allow or disallow. Sometimes you wonder if 600 more staff have been employed to tackle MTIC fraud, then why has so much time accumulated to reach a decision on whether to “Allow or Disallow” the taxpayer the right to deduct. Especially when a taxpayer like OTL has demonstrated and proved that it has never been irresponsible or not careful in conducting its transactions or informing HMRC all the relevant details to give rise to input tax.

In previous instances HMRC built cases on innocent traders based on the relevant information obtained during the verification exercise only to withdraw cases close to a hearing because of lack of evidence. This ambiguity on the part of the commissioners raise serious questions in the manner and method the verifications exercises are conducted, only to save money on MTIC and pay the saved money in costs and repayment supplements to a taxpayer.

23 January 2007

Memorandum by PricewaterhouseCoopers

PricewaterhouseCoopers LLP (“PwC”) is pleased to submit evidence to the UK Parliament European Union Committee inquiry into carousel fraud in the EU. PwC fully supports all effective and proportionate steps taken by any body to tackle this fraud. PwC has taken active steps in order to ensure that it does not engage with organisations that may be involved in carousel fraud, including additional client acceptance procedures for clients in industries where carousel fraud is thought to be concentrated.

Introduction: The Nature of the Fraud

Carousel fraud derives from two key features of the EU VAT system:

1. A VAT registered business can purchase goods from a business elsewhere in the EU without the need to pay VAT to the supplier. Instead, VAT is accounted for through “acquisition accounting” that requires the purchaser to account for the VAT through entries on its VAT return.
2. A VAT registered business that sells goods to another customer in the same EU member state collects VAT from the customer and should remit this VAT to the local tax authority. The VAT registered business is in effect acting as a tax collection agent of the tax authority. These two features combine to allow a business to purchase goods without a requirement to pay VAT, and to then sell those goods and collect VAT from its customer. Legitimate businesses remit that VAT cash amount to the tax authorities, whereas fraudulent businesses “disappear” without paying that VAT to the tax authorities. A number of variations of the fraud have developed, all of which rely on these two features. However, it should also be noted that businesses that purchase goods from domestic suppliers and sell those goods to domestic customers could also perpetrate the fraud by relying only on the second characteristic above and by not declaring (or underdeclaring) VAT on sales revenue. However, it is the combination of the characteristics above that creates the ability to generate large amounts of fraudulent funds in a relatively short period of time.

ARE THERE FLAWS IN THE LEGISLATION?

The VAT system is designed to collect tax on the value added by each participant on the supply chain, and there is a reliance on each participant in the supply chain to collect tax and remit this to the tax authorities. It could be argued that this reliance on taxpayers to assess and collect tax is a fundamental flaw in the system. PwC does not agree with this analysis, because many tax systems, including personal and corporation taxes in the UK, rely on similar self assessment and payment by taxpayers.

With carousel fraud, the VAT system can in itself be the reason why a transaction takes place. Carousel fraud provides an incentive for criminals to enter into specific transactions with the sole intention of collecting VAT that will not be remitted to the tax authorities, generating cash that can then be misappropriated.

This suggests that there are two approaches that could successfully combat this fraud:

— increased control over those businesses that are VAT registered and that currently have a right to collect VAT on behalf of the tax authorities; and
— eliminating the ability of VAT registered businesses to collect VAT on behalf of the tax authorities.

IMPACT ON THE INTERNAL MARKET

Carousel fraud has led to a number of outcomes that have a negative impact on the efficiency of the economy, including:

— Extra administrative burdens are created for both businesses and the tax authorities who have to develop and implement procedures designed to combat carousel fraud.
— Legitimate businesses may suffer through delays in receiving VAT repayments.
— The fraud may create transactions that have no economic benefit, and exist only to create the conditions necessary for a fraudulent trader to collect VAT and misappropriate this.

These wider economic impacts, in addition to the misappropriation of government funds, create compelling reasons for the development of policies that will effectively deal with carousel fraud.

THE UK’S MEASURES TO COMBAT CAROUSEL FRAUD

(1) HMRC in the UK have attempted to place increased controls over businesses that collect VAT. This has extended to undertaking detailed investigations of businesses involved in certain industry sectors and withholding repayments of VAT from traders.

It is the view of PwC that this action has been disproportionate in that it has impacted substantial numbers of businesses that have no involvement with carousel fraud. In saying this, we are fully aware of the scale of the problem HMRC is facing and we agree with the principle of HMRC carrying out checks. The cash flow impact of withholding VAT repayments has led to a number of businesses ceasing to trade, and the legitimacy of the legislation adopted in the UK and the approach of HMRC has successfully been challenged in the courts.

The issue is how long HMRC will continue to withhold their repayments and if, in the meantime, innocent companies may be liquidated due to the time being taken to verify supply chains.
If a trader has taken reasonable steps, including due diligence checks on his suppliers and customers, and has procedures in place for his own records to demonstrate he is taking every precaution which could reasonably be required of him, it follows that even if he is unwittingly part of a fraudulent supply chain, with the above in mind, HMRC should be repaying his input tax. However, the current actions by HMRC do not allow for traders to have their systems and processes taken into consideration and consequently all traders are being treated the same regardless of their intentions.

It would be helpful if HMRC could consider a more targeted and objective approach to the current wholesale withholding of input tax to enable more dialogue between HMRC and affected traders who wish to continue in business for legitimate reasons. Until this approach is adopted we believe many businesses will be forced into legal action through judicial reviews which not only take time but also cost significant sums of money.

(2) Legislation was adopted in the Finance Act 2003 amending paragraph 4 of Schedule 11 of the VAT Act 1994 to combat VAT fraud. It gave powers to HMRC to seek security with regard to payment of VAT credits and gave ambiguous scope to the information that HMRC could seek from the taxpayer. The legislation was challenged in the case of C & E Commrs and Attorney-General v Federation of Technological Industries (Case C-384/04). The European Court of Justice effectively allowed the measures but only where the taxpayer “...knew, or had reasonable grounds to suspect, that some or all of the value added tax payable in respect of that supply, or of any previous or subsequent supply, would go unpaid ...”.

This outcome creates a serious difficulty to using this legislation effectively because it creates a subjective test in order to establish whether a business has an entitlement to recover VAT. A subjective test means that disputes are more likely to arise due to differences in opinion between taxpayers and the tax authorities in relation to what should and could have been known at the time of the transaction. PwC is aware that HMRC have used this issue in order to continue to block VAT repayments for some traders.

We have also noted instances where HMRC have been reluctant to provide businesses with any certainty that checks that are voluntarily performed by a business on its supply chain will provide a measure of protection from the actions of HMRC, and this has created frustration on the part of the large majority of businesses that pay VAT correctly.

(3) Finance Act 2003 also introduced what is now S77A VATA 1994. This gives HMRC power to, in effect, penalise an innocent trader in a chain of transactions where a fraud has taken place. PwC has always had severe reservations about the fairness of this approach, which has of course been significantly discredited in the Bond House/Optigen cases. We think it unfortunate that the reverse charge route was not tried earlier.

(4) The Finance Act 2006 has introduced measures that shift the burden of accounting for the tax to the recipient of a supply (the “reverse charge” procedure). This means that VAT is not physically paid to the supplier, and so cannot be misappropriated if that supplier is fraudulent. The reverse charge has been used to counter, effectively, VAT fraud in other business sectors, such as fraud in the gold market. The UK is currently awaiting permission from the EU to put the new system into effect.

PwC considers that the reverse charge is likely to be effective in mitigating carousel fraud because it prevents businesses collecting VAT from suppliers, which is then at risk of misappropriation. It is also welcome because it should not adversely impact the businesses that are not engaged in carousel fraud. However, PwC is of the view that there is a risk that carousel fraud may move to be perpetrated in business sectors that are not subject to the proposed VAT legislation. This may mean that the legislation may have to be extended in future and in turn raises a concern about the possible impact of frequent changes for compliant taxpayers.

Measures Suggested by the EU Commission and the Actions of Member States

The measures suggested by the Commission are set out in a document entitled “EU coherent strategy against fiscal fraud—Frequently asked questions”, MEMO/06/221 dated 31 May 2006.

The Commission advances a number of strategies including:

- enhanced co-operation tools between Member States and third parties;
- using information technology to effectively identify and stop fraud; and
- possible more extensive use of the reverse charge.

PwC believes that the solution most likely to meet the needs for immediate and effective action against fraud is the use of the reverse charge mechanism. The additional proposals of the EU Commission will be helpful but are likely to take time to implement, given the requirement for international agreement.
Individual member states can act within these broad parameters in order to combat carousel fraud. The use of a 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 also establish a framework to tackle the fraud more effectively in the future. This will be of assistance if, as PwC anticipates, carousel fraud moves out of industries that have been subject to specific VAT legislation that applies the reverse charge to other industries that are not subject to this VAT treatment. This framework also allows individual member states to retain control of the implementation of national VAT systems effectively.

**Summary of PwC’s Views**

As we noted at the start of this paper, PwC fully supports all effective and proportionate steps taken by HMRC to tackle this fraud. Over view is that the UK legislation that has been introduced will have a significant impact on carousel fraud. It will ensure that innocent businesses do not suffer an economic consequence from efforts to combat carousel fraud.

We are concerned that there will be a migration of the fraud to other business sectors, and we are concerned about the implementation of the changes happening too quickly after the granting of the derogation without a period of adjustment for businesses generally.

PwC does not consider that the proposed UK legislation will be effective in tackling all VAT fraud, of which there are many types, but it should assist in safeguarding the UK exchequer from the sustained attached that carousel fraud has represented in recent years.

*September 2006*