8-13-2013

Tackling VAT Fraud: Thirteen Ways Forward

Richard Thompson Ainsworth

BU School of Law

TACKLING VAT FRAUD: THIRTEEN WAYS FORWARD

Boston University School of Law Working Paper No. 13-36
(August 13, 2013)

Richard T. Ainsworth
Boston University School of Law

TACKLING VAT FRAUD: THIRTEEN WAYS FORWARD

Richard T. Ainsworth

In a May 31, 2006 Communication to the Council, the European Parliament, and the European Economic and Social Committee, the European Commission indicated a need to develop a co-ordinated strategy to improve the fight against fiscal fraud [COM(2006) 254 final].[1] Although the Communication considers fiscal fraud broadly (VAT, excise duties and direct taxes) the most pressing need seems to be for a VAT strategy that will effectively deal with carousel fraud.

Estimates of annual EU losses to VAT fraud are in the range of 60 billion euros,[2] with about 40% of that amount attributable to "missing trader intra-community" (MTIC) or carousel fraud. Best estimates of EU losses to carousel fraud are put at 23 billion euros annually.[3] The UK estimates its carousel fraud losses to be 2.98 to 4.47 billion euros annually.[4]

To this end the Commission is hosting Fiscal Fraud – Tackling VAT Fraud: Possible Ways Forward. The March 29, 2007 conference is constructed workshop-style, and divided into three concurrent sessions:

1. VAT fraud: what problems does it cause to business and how can they assist the tax administration in combating it?
2. Enhancing the fight against fraud and the burden on businesses: striking the right balance
3. Changing the VAT system: the ultimate solution?

THIRTEEN PROPOSALS

Over the years, a large number of solutions for carousel fraud have been advanced. They can be divided into traditional and current proposals. Traditional proposals date from considerations surrounding the design of the EU VAT in the absence of border controls. Recent proposals are focused more narrowly on carousel fraud. This article summarizes (in advance of the March 29 "Ways Forward" conference) thirteen most discussed proposals for change.

Traditional Proposals

There are seven traditional proposals. The first two eliminate carousel fraud by taxing intra-Community transactions at origin. The next four eliminate carousel fraud by

[1] *Available at* http://eur-lex.europa.eu/LexUriServ/site/en/com/2006/com2006_0254en01.pdf
[2] Commissioner László Kovács, *Speech at the Press Conference on the Adoption of the Communication on Fraud* (May 31, 2006) *available at* http://ec.europa.eu/commission_barroso/kovacs/speeches/introductory_speech_REV4.pdf
[3] Europol Press release, *Experts discuss 'Missing Trader Inter-Community Fraud*, (Dec. 13, 2006) *available at:* http://www.europol.europa.eu/index.asp?page=news&news=pr061213.htm
[4] H.M. Treasury, 2006 PRE-BUDGET REPORT: INVESTING IN BRITAIN'S POTENTIAL – BUILDING OUR LONG TERM FUTURE 126 (Dec. 2006) Cm 6984, *available at*: http://www.hm-treasury.gov.k/media/5CC/43/pbr06_completereport_1439.pdf

imposing a community level "Euro-VAT" to coordinate transactions among Member States. The final proposal requires pre-payment for intra-Community transaction.

(1) *Common VAT*.[5] Called an "origin system" of VAT by the Commission, this proposal, based on research efforts dating to the 1980's, was for the taxation of intra-community sales at the rate of the country from which the goods are supplied. Under this system, the importer would be deducting in one Member State the VAT that was collected in another Member State, resulting in a displacement of VAT revenues.

The Common VAT requires a clearing mechanism to reallocate VAT revenue from origin to destination jurisdictions. Two approaches to clearing were considered. The initial proposal (1987) measured the amount to be allocated on a transactional basis [COM(1987) 323 final] the 1996 proposal used aggregate consumption data. Both approaches were considered complex. More critically, clearing mechanisms, no matter how they are designed, create disincentives to audit cross-border transactions.

(2) *Vanistendael's foreign tax offices proposal*.[6] In 1995 Professor Fransiscus Vanistendael proposed to tax all cross-border transactions at the rate of the country of destination. To ease business compliance burdens he required destination jurisdictions to establish branch tax offices in the country of origin to accept tax payments, issue refunds and handle all foreign VAT matters.

Vanistendael's proposal ran into problems with compliance cost symmetry – in both businesses and tax administration contexts. Compared with the simple zero-rating of all intra-Community transactions, Vanistendael's would require exporters to comply with the tax rules of 14 other jurisdictions. Deemed too costly and too complex in 1995, Vanistendael's approach would be even more difficult today with 27 Member States.

(3) *CVAT*. The Compensating VAT (CVAT), designed by Ricardo Varsano and extended by Charles McLure,[7] adds a federal VAT (only) at internal borders. Under the CVAT a Member State would still zero-rate exports, and the importing Member State would still require the importer to reverse charge at the rate imposed in that jurisdiction.

The critical addition made by the CVAT is that when exporting (across an internal border) a federal obligation arises to collect an additional federal VAT – the CVAT. The importing party deducts this amount in full, but only in conjunction with filing a return that includes the required reverse charge.

Seen in terms of carousel fraud, the federal level CVAT prevents goods from entering into free circulation in a domestic economy unburdened by VAT in the same

---

[5] European Commission, A Common System of VAT: A Program for the Single Market," COM(1996) 328 final.

[6] Fransiscus Vanistendael, *A Proposal for a Definitive VAT System Taxation in the Country of Origin at the Rate of the Country of Destination, Without Clearing*, 1 EC TAX R. 45, 48 (1995).

[7] Charles McLure, *Implementing Sub-national VATs on International Trade: The Compensating VAT (CVAT)*, 7 INT'L TAX & PUB. FIN. 723-40 (2000).

way that the Common VAT does. Where the Common VAT burdens goods with VAT of the *origin jurisdiction*, the CVAT burdens goods with a *federal* VAT.

(4) *VIVAT*. The Variable Integrated VAT (VIVAT), designed by Michael Keen and Stephen Smith,[8] is a two-tiered tax that relies on a Euro-VAT in conjunction with a Member State origin-based retail sales taxes (RST).[9] VAT and RST rates are coordinated. Once the Euro-VAT rate is established, the rate of the RST becomes the difference between the federal rate and state's decision on how heavily to burden final consumption.

The VIVAT does not distinguish between local and cross-border transactions; it distinguishes between B2B and B2C transactions. Carousel fraud is eliminated because intra-community transactions are not zero-rated. However, simple "missing trader" fraud is very possible both at the B2B level, and (depending on rate differentials) at the B2C level.

The VIVAT's dilemma is that by setting the VAT rate low to avoid problems with excess VAT refunds (as Keen and Smith recommend[10]) the rate of the RST will breed fraud. In some Member States the origin-based RST will rise to 20%, in others it will be 10%. Cross-border B2C missing trader/ missing consumer fraud will proliferate, as will domestic "shell business" purchasing for personal consumption at the lower business rate. This is a situation that begs for an add-on use tax, similar to those in all US states with an RST.

(5) *Dual VAT – HST version*. Richard Bird and Pierre Gendron[11] suggest that there are a variety of Canadian experiences with dual (federal/ provincial) consumption taxes that might be useful for the EU to consider as it searches for a fraud-free solution to the operation of the VAT in a single market.[12]

The HST is one of these models. Under the HST the federal government administers and collects the local VAT as part of a uniform national VAT.[13] The Provincial government determines a portion of the combined rate, but the base is uniform. Newfoundland, Nova Scotia and New Brunswick participate in the HST. Each imposes an 8% provincial rate that is combined with the 6% federal rate.

---

[8] Michael Keen & Stephen Smith, *The Future o f Value Added Tax in the European Union*, 23 ECON. POL'Y 373-411 (1996).

[9] A destination-based RST would violate compliance symmetry. Cross border B2C transactions would be subject to the tax rates and rules of the 26 other Member States.

[10] Michael Keen & Stephen Smith, *supra* note 8, at 404.

[11] Richard Bird & Pierre Gendron, *Dual VATs and Cross-Border Trade: Two Problems, One Solution?* 5 INT'L TAX & PUB. FIN. 429 (1998).

[12] Five Canadian provinces (Ontario, British Columbia, Prince Edward Island, Saskatchewan and Manitoba) combine a provincial level RST with the federal GST, and could provide a practical model for the VIVAT, except the provincial/ federal rates are not linked as in the VIVAT, and all the Canadian RSTs are destination-based, not origin-based as in the VIVAT.

[13] Richard Bird & Pierre Gendron, *supra* note 11, at 435-37.

(6) *Dual VAT – QST version*. If a high value is placed on local autonomy, Bird and Gendron suggest that the Quebec Sales Tax is the template for the EU to consider.

The defining characteristic of the QST/GST relationship is that the local government administers both taxes. It is a bottoms-up administration, unlike the HST which is administered top-down by the federal government. In addition, because the national GST is included in the QST tax base there is an incentive for sub-national administrators to pay close attention to the GST. Minor differences in the tax base have not caused a problem.

Because each of the add-on federal VAT proposals (CVAT; VIVAT; Dual VAT-HST; Dual VAT-QST) relies on the federal audit to cross-check (and ensure) that the sub-federal tax has not been evaded, the critical question is: Do any of the Canadian dual VATs prevent carousel fraud? The answer is disappointing. Good theory is not supported by good practice.

The largest GST frauds in Canadian history are carousel frauds ($50 million).[14] These frauds frequently involve the sale and re-sale of automobiles[15] or heavy equipment.[16] They are known as “car-flipping” or “equipment-flipping” schemes. These schemes, “… generate profit by rapidly buying and selling vehicles, while abusing input tax credits or failing to pay GST/HST.”[17] Schemes costing millions of dollars in revenue have been a problem since 1994.[18] The Canadian experience is a “wake-up” call to those who believe this fraud is reasonably confined to the cell phone and computer chip market.

(7) *PVAT*. The Prepaid VAT (PVAT), developed by Satya Poddar and Eric Hutton,[19] requires vendors to collect VAT on all sales, domestic and interstate, with the sole exception of interstate sales where the buyer prepays the VAT to the state of destination – and provides proof of this payment to the vendor. Proof would be a tax deposit receipt.

The PVAT solves carousel fraud by re-introducing restrictions on the free flow of goods. It turns the vendor into a customs agent. Goods are not released into cross-border trade without payment of tax either at origin at destination. If tax needs to be paid at origin to get goods released expeditiously, problems will arise over the crediting of origin

---

[14] OMVIC, 2004 ANNUAL REPORT & 2005 BUSINESS PLAN, 9 *available at*: http://www.omvic.on.ca/News/Annual_Report_2004.pdf

[15] Regina v. Prokofiew (Ontario Superior Court of Justice) 2004 CarswellOnt 3827; [2004] G.S.T.C. 103 (Mar. 22, 2004).

[16] Regina v Prokofiew; Regina v. Solty, (Ontario Superior Court of Justice) [2005] O.J. No. 1824; 2005 ON. C. LEXIS 2016 (Apr. 11,2005)

[17] Canadian Customs and Revenue Agency, Performance Report, DPR 1999-2000, at Strategic Goal 3, n.8 *available at*: http://www.tbs-sct.gc.ca/rma/dpr/99-00/ccra-adrc/CCRA9900dpr-PR_e.asp?printable=True

[18] Regina v. Paul Foy, 2003 CarswellOnt 5861; [2005] G.S.T.C. 31 (Mar. 3, 2003) at ¶ 34 &45

[19] Satya Poddar & Eric Hutton, *Zero-rating of Interstate Sales Under a Sub-national VAT: A New Approach*, in NATIONAL TAX ASSOCIATION PROCEEDINGS: NINETY-FOURTH ANNUAL CONFERENCE (2001) 200-07.

taxes at destination, or about the refund of these taxes at origin (upon proof of payment at destination).

Like the VIVAT, the PVAT has difficulties with B2C transactions. If tax rates among the Member States are not harmonized an incentive develops for consumers to rate-shop. This leads correspondingly to an incentive for high-tax destination states to adopt compensating use taxes. The question then becomes whether or not the destination state will credit consumers with an origin tax (with the understanding that the origin state will pass along the amount collected at origin to the destination state), or whether the consumer will be required to file a refund claim in the origin jurisdiction.

Recent Proposals

With the exception of the Digital VAT (D-VAT), each of the recent proposals for resolving carousel fraud were considered at the September 29, 2003 Tax Policy Conference of the Ifo Institute for Economic Research.[20] This conference was a watershed event for new solutions. It considered an exemption model, two reverse charge models and two "pay-first" models.

(8) *Mittler Model*. The Mittler Model is an electronic exemption certificate system. The American retail sales tax is similarly based on exemption certificates. Although proposals have been made to automate this core functionality in the US, no American jurisdiction has done what the Mittler Model proposes. American exemption certificates remain paper-based.

Procedurally, under the Mittler Model firms qualifying for exempt purchases receive a special identification number, called an F-number ("F" standing for "free"). Firms present their F-number to suppliers to indicate that they are entitled to make purchases "free of VAT." The supplier then checks the F-number through an electronic registration system, and when confirmation of validity is received an invoice net of VAT is issued. The supplier does not collect VAT. The purchaser neither pays VAT nor has the right to an input tax deduction on these purchases. The supplier gives an on-line notification of exempt transactions. Buyer and seller are required to report exempt sales and purchases on their respective VAT returns.

Seen through American eyes the Mittler Model is a use-based exemption system that includes sales-for-resale as a category of exempt-use. The American experience suggests that two issues are raised by this system: (1) how to determine the validity of the certificate, and (2) whether to enforce a "good faith" requirement – the proposition that only sellers who accept apparently valid certificates in good faith are absolved from liability to collect the tax. The Mittler Model answers the first question, how it deals with the good faith issue is not clear.

[20] Ifo Institute, Value Added Tax Evasion and Model Approaches for its Avoidance (Sept. 29, 2003) *available at* http://www.cesifo-group.de/portal/page?_pageid=36,385339&_dad=portal&_schema=PORTAL&item_link=steuer-gemeinschaftskonferenz-2003-bericht.htm (English and German).

Both the Mittler Model and the American retail sales tax generate the great bulk of their revenue at exactly the same point – the point where sales are made to end consumers. As a result, both systems unintentionally (a) encourage buyers to avoid the tax through improper use of exemption certificates, and (b) encourage sellers to find ways to make final sales without including tax. An assessment of the Mittler Model would benefit from a consideration of the impact that these avoidance pressures have on the American retail sales tax where the rates are approximately 7% (as opposed to 20%), and where many states have a significant "excess registration" problem.[21]

(9 & 10) *Two reverse charge models*. The Ifo institute considered two comprehensive reverse charge models, one with an *input tax settlement* feature, the other with an additional *joint and several liability* feature. Because both models share the same core functionality for countering carousel fraud, they are considered together.

A reverse charge prevents carousel fraud in the same manner that an exemption system does. Taxable businesses making purchases (for which they have the right to claim an input VAT deduction) pay no VAT. They self-assess, and in most cases claim a credit simultaneously. The invoice includes no amount for VAT. Without VAT in-hand, the seller no longer has an incentive to "disappear."

This is a workable option. It is a solution however, that places exceptional pressure on an accurate determination *by the seller* of the buyer's qualifications for input credit. The Ifo Institute's reverse charge models rely on an automated identity system that is similar to the "F-number" mechanism under the Mittler Model. In a comprehensive reverse charge regime the critical distinction is between B2B and B2C transactions. The seller would not tax sales for business use, whereas sales for personal consumption would be taxed. In a partial reverse charge regime the seller needs to further distinguish among B2B sales based on the type of goods sold or how they will be used. This is an exceptionally difficult task in the American context.

The American retail sales tax does employ a very successful B2B reverse charge mechanism – the Direct Pay Permit (DPP) authorization system. The DPP allows sellers to issue invoices free of sales tax to buyers (who would otherwise be obligated to pay tax to the seller). The buyer then self-assesses. The vast majority of American jurisdictions imposing a retail sales tax have DPP systems to reverse the liability to collect the tax. Most are automated.

The critical difference between the Ifo and the American reverse charge models is that the Ifo proposals are universal and mandatory, whereas the American DPP is selective and voluntary. The Commission favors a hybrid type of reverse charge solution – one that is (a) selective – confined to a market segment like cell phones, and (b) mandatory – all businesses within that segment must apply it.[22]

---

[21] JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 140 & n.3 (2d ed. 1994)

[22] *Compare* COM(2006) 555 final (indicating the Commission's favorable opinion of the UK application for a partial reverse charge mechanism in cell phones and computer chips) *with* COM (2006) 404 final

(11 & 12) *Two pay first models.* The Ifo Institute's "pay first" models have theoretical and practical heritages. The 2001 Poddar-Hutton PVAT is their theoretical analogue. In practically terms, there are (or have been) pre-payment (or banking-system/ controlled payment) models in Bulgaria, France, Hungary, Turkey, and Azerbaijan. The Bulgarian VAT Bank regime, established in July 2002, was removed upon Bulgaria's accession to the EU (January 1, 2007).

The linchpin of the Ifo Institute's "pay first" models is the requirement that buyers only claim input tax deductions if they can prove that the *seller* has paid over the VAT to the authorities. There are two permutations to the Ifo "pay first" proposals – non-cash (trust account) and cash (tax stamp) versions. Each can function independently, or they can be combined into a comprehensive "pay first" model.

The non-cash payment (trust account) model. Under this model, if an invoice is paid by bank transfer or credit card the amount of VAT (shown separately on the invoice) is required to be directly passed to the tax authorities via a trust account established at the bank. The seller's bank acts as a trustee of government funds.

The IMF reports that in countries where banking-system dependent regimes are used, the system is mandatory for a defined set of high value transactions. It is not universally mandatory, as under the Ifo model.

The IMF is critical even of these limited systems. It indicates that forcing traders to pass transactions through banks disrupts business. IMF surveys indicate that some traders prefer to be paid in cash, particularly when they are concerned about customer solvency. For this reason, if the Ifo Institute's pay first model were to be adopted comprehensively it is best to merge the (non-cash) trust account model with (cash) tax stamp model.

The cash payment (tax stamp system) model. The cash payment model requires prepayment of VAT by the *seller*. There are two variations. The first uses a stamp machine similar to a postage meter that is filled with pre-paid stamps against which the VAT can be debited. The second system is modeled on the Italian Scontrino model, where a VAT receipt must accompany each sale. In this case, a tax stamp must be affixed to the receipt.

Virtual stamps are contemplated under the Ifo proposal. Each cash register is required to be connected to an on-line database so that at the time of each sale the *seller* automatically purchases a VAT stamp. The stamp is passed to the buyer along with the register receipt. Businesses entitled to a credit would provide the stamped receipt as documentation.

(indicating the Commission's unfavorable opinion of the German and Austrian application for a comprehensive reverse charge mechanism).

If both of these *cash payment* models were adopted and applied comprehensively in an economy, IMF reservations about mandating the use of the banking system might be answered. Businesses preferring to conduct business in cash may do so, but they must issue a receipt with a VAT stamp.

However, like the PVAT, the Ifo Institute's "pay first" regimes solve carousel fraud by re-introducing restrictions on the free flow of goods. Once again, vendors become customs agents. Goods will not be released into cross-border trade without payment of tax, and much of it will be at origin. As with the PVAT a clearing function is needed.

(13) *Digital VAT*. The Digital VAT (D-VAT)[23] proposes no structural changes to the operation of the EU VAT other than the adoption of rules similar to those recently enacted in France to deal with carousel fraud.[24] The D-VAT is premised on the penetration of technology in the modern economy, and suggests that VAT administrations should begin to certify VAT calculation engines along the line of the Streamlined Sales Tax in the US.

The French rules that were recently adopted target carousel fraud. They apply to businesses that make domestic purchases of goods from French suppliers and/or any business that makes intra-community supplies to or from France. The rules require a demonstration that all necessary steps and appropriate due diligence has been undertaken to ensure that clients and supplies are bona fide.

If businesses do not meet these requirements the French exemption for intra-community supplies is disallowed (or the recovery of VAT incurred on a local purchase of goods is disallowed). The rules require a demonstration that:

(1) Customers carry out actual business activities;
(2) Suppliers that supply French businesses with goods (and that charge VAT) are not involved in a carousel fraud scheme; and
(3) All VAT due during the previous supply of the same goods has been paid to the tax authorities.

The French rules do not explain how a business is to meet these standards, other than performing due diligence audits on customers. The D-VAT can provide this due diligence. Under a system where VAT calculation engines are certified the French "proof" could be accurate and automated (if both buyer and seller operated certified systems). Data exchanges between buyer and seller could confirm that both ends of a cross-border transaction were handled properly. A certified seller's system would only zero-rate exports if it received input about the buyer status. A certified buyer's system would reverse charge in all cases where the seller's system was authorized to zero-rate.

[23] Richard T. Ainsworth, *The Digital VAT (D-VAT)* 25 Virginia Tax Review 875 (2006); Richard T. Ainsworth, *Carousel Fraud in the EU: A Digital VAT Solution* 42 TAX NOTES INT'L 443 (May 1, 2006).
[24] *La loi de Finances* rectificative pour 2006 (n°2006-1771) du 30 décembre 2006.

A D-VAT approach to carousel fraud can be universal or selective. The American approach, as in the case of Direct Pay Permits, would be to have a voluntary regime. Following the Streamlined Sales Tax off-site third-party certified service providers (CSP) could be used. Other models for certification in the American context include automated systems (CAS) installed in a company's ERP system, and certified proprietary software (CPS) systems.

There is a cost to the D-VAT, and most of that is embedded in the certification process. In a sense, certification is really an advanced audit function combined with an Advance Pricing Agreement. Under the Streamlined Sales Tax online access to a CSP is provided free of charge to taxpayers who agree to collect taxes on remote sales. Similar arrangements for free access in the EU could be arranged, particularly for small businesses or those in "suspect industries." Business operating outside of a voluntary certification regime could be subject to more intense audit, or perhaps subject to a less than immediate VAT refund regime.