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WILL THE EU SHOW THE US THE "WAY FORWARD?"

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On Thursday, March 29, 2007 the European Commission, Directorate-General for Taxation and Customs Union, will host a one-day Conference on Fiscal Fraud – Tackling VAT Fraud: Possible Ways Forward. The conference is based on the Communication of May 31, 2006 explaining the need to develop a coordinated strategy to improve the fight against fiscal fraud [COM(2006) 254 final].[1]

The Commission estimates that losses to VAT fraud are in the range of 60 billion euros per year.[2] It warns however, that these estimates are highly speculative as they are based on extrapolations from a limited set of country-specific studies. German Finance Minister Peer Steinbrueck, for example, estimates Germany's revenue losses from all types of VAT fraud at between 8 and 10 billion euros annually. An in-depth, EU-wide survey by the Commission is forthcoming.

About 40% of VAT fraud appears to be of a specific type, "missing trader intra-community" (MTIC) or carousel fraud. The best estimates of EU losses to carousel fraud are put at 23 billion euros annually.[3] UK studies put domestic losses from carousel fraud at 2.98 to 4.47 billion euros.[4]

Both the magnitude of these losses, and the fact that carousel fraud involves exclusively B2B transactions that frequently involve legitimate businesses, make it clear that the Commission will target the business community at this conference. The changes that the Commission has under consideration will directly impact the way business is conducted in the EU. The Commission considers it important therefore to engage in a dialogue with those who will be affected.

Carousel fraud poses special problems, because unlike the other types of VAT fraud (the 60% figure) carousel fraud seems to be particularly resistant to traditional VAT

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[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 (indicating that "… attempted MTIC fraud was between 3.5 billion pounds and 4.75 billion pounds in 2005-06; with an estimated negative impact on VAT receipts during the year of between 2 billion pounds [or 2.98 billion euro] and 3 billion pounds [or 4.47 billion euro].") *See also*: H.M. Revenue & Customs, MEASURING INDIRECT TAX LOSSES – 2006 6 & 21-25 (Dec. 2006) *available at*: http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_026423 (setting out the methodology used to determine estimates in the 2006 PRE-BUDGET REPORT.)

enforcement efforts. It is fast moving, conducted for large sums, frequently connected to organized criminals, and very technologically savvy. Some carousel frauds are conducted entirely in a virtual world that is, except for the fraudulent demand for VAT refunds which occur in the very real world and for millions of euros at a time.

The Problematical 40 Percent

Carousel fraud exploits the crediting of tax paid on purchased inputs against the tax due on sales. The point of vulnerability is the zero-rating of exports. In a destination-based VAT exports are zero-rated and imports are subject to tax at the border. The danger (and the enticing element for fraudsters) is the potential for goods to be brought into free circulation in a domestic market unencumbered by VAT. In most instances, the administrative structure that prevents this is the customs officer. However, customs officers have been removed from the internal borders of the EU and as a result fraud has proliferated.

Background. Before January 1, 1993 customs provided normal administrative oversight at all European borders. Even for intra-community transactions, customs agents (a) verified entitlement to zero-rating on exports and (b) imposed VAT based on applicable rates on importation. Because all EU countries impose VAT, both functions were performed at the internal borders, and this hampered the free flow of commerce.

On January 1, 1993 customs agents were removed from the internal borders and the single European market was created. VAT administration needed to change and the compromise that was worked out among the Member States in 1991 was implemented.[5] The compromise however, dislocated a bedrock principle of the VAT – the system of fractioned payments.[6] VAT at the internal borders was to be deferred. Goods could now enter domestic markets unburdened by VAT, although they were not supposed to be placed in free circulation.

The compromise is premised on interlocking legal requirements and tax accounting rules. Heightened administrative cooperation, the VAT Information Exchange System (VIES), and the Intrastat system were instituted to support enforcement of the new legal and accounting requirements. A cosmetic change was also made. Intra-Community trade no longer used the terms “import” and “export.” Instead, “intra-Community acquisitions” (imports) and “intra-Community supplies” (exports) were the operative terms.

How carousel fraud works. Carousel fraud is a willful violation of the new legal and accounting requirements. It works when a seller (A) in Member State 1 makes an

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[5] 1991 O.J. (L 376) 1; White Paper COM(85) 310 final, 52 *available at*: http://europa.eu/documents/comm/white_papers/pdf/com1985_0310_f_en.pdf.

[6] The VAT fundamentally contrasts with the RST at this point. As a multi-stage consumption tax the VAT collects a fraction of the total VAT that will be ultimately be due on final consumption at each stage of production, based on the value added at that stage. The RST in contrast (a single-stage consumption tax) collects all of the tax due at the point of final sale.

exempt intra-community supply of goods to a (soon to be) "missing trader" (B) in another Member State 2. This company (B) acquires the goods without paying VAT, and subsequently makes a domestic supply to a third company (C). Company C is frequently called the "broker."

The "missing trader" (B) collects VAT on its sale to the "broker" (C), but does not pay the VAT over to the government. Company B disappears along with the VAT. Company B neither files a return, nor does it perform the required "reverse charge" procedure, which essentially is a self-assessment of the VAT due on the importation of the goods from A.

When the "broker" (C) claims an input credit on the VAT it paid to the "missing trader" (B) Member State 2 suffers the loss. In a fully operational carousel the "broker" (C) will re-sell the goods back across the border to the initial seller (A). This sale is also an exempt intra-community supply. The same goods can then be sold once again on this "carousel" to (B). When (A), (B), and (C) are operating in tandem and are aware of the fraud, it is a relatively easy matter to apply joint and several liability provisions and hold C liable for the VAT not remitted by B.[7]

A common practice has developed whereby legitimate companies, called "buffers," are (unbeknownst to them) placed between the key operatives in the scheme both to (a) distort trading patterns and make investigations difficult and to (b) make it more difficult to apply the joint and several liability provisions in VAT statutes. "Buffers" may be completely unaware of the fraud, although based on the irregularity of the transactions they may suspect, but have no direct knowledge that something is amiss.

The Federation of Technological Industries, a trade body, reports that carousel fraud investigations are causing very significant delays in VAT refund recoveries, and that these delays are harming legitimate traders. Heightened enforcement actions have in some instances resulted in delays long as 12 months when the norm for VAT refunds had been 30 days.

American Interest

American interest in the EU VAT fraud debate is both practical and theoretical. The practical interest is obvious, the theoretical probably less so. Hit with significant delays in the receipt of sizable refunds, American businesses in some sectors (notably cell phone and computer chips) are deeply concerned with developing enforcement efforts. At a minimum, it is hoped that the new enforcement efforts will stem the growing delays in processing legitimate refunds.

As a theoretical matter fraud concerns resonate deeply among American advocates of a federal level VAT in the US. American policymakers have long looked to the EU for an established body of best practices to counter traditional fraud activities in

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[7] *See* joined cases of *Optigen, Fulcrum and Bond House Systems* (Cases C-354/03, C-355/03 and C-484/03).

the VAT (the 60% figure). But what about the other 40% of VAT fraud, the carousel fraud part? Is carousel fraud likely to be an American problem too if we adopt the EU-style of VAT? The answer is "yes," and "yes" with an exponential emphasis.

One of the strengths of the American tax system is the way the network of federal, state and local tax systems interact with one another. Lower levels of government frequently "piggy back" (almost always with local differences) on the tax systems of the level of government immediately above.[8] Locals adopt country structures, counties adopt state systems, and states frequently follow the federal regime. Thus, if a EU-style VAT is adopted at the national level most advocates anticipate that a significant number of sub-national governments would eventually "piggy back" the national VAT.[9] It is here, among the 7,588 (at last count)[10] state and local consumption tax jurisdictions, each of which participants in the American single market (constitutionally unencumbered by customs controls at the internal borders) that one would expect to see the American version of carousel fraud.[11]

Not that the problems posed by carousel fraud at the sub-national level would prevent the adoption of a national VAT, but that the problems posed by it would need to be resolved through a comprehensive data exchange (at the transactional level) among federal and sub-national levels of government. An administrative mechanism for this data exchange has been set out in the Digital VAT (D-VAT) proposal to the President's Advisory Panel on Federal Tax Reform.[12] A companion proposal in the specific context of resolving carousel fraud in the EU has also been advanced.[13] Canada may offer important lessons in the coordination of national and sub-national consumption taxes,[14] however the magnitude of the Canadian coordination problem pales in comparison to the US.[15]

Inserting a national credit-invoice VAT into the U.S. fiscal fabric would be to set out the welcome mat for an American carousel fraud if the tendency for national, state and local tax systems to "piggy backing" on one another is taken into account. Thus, at a

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[8] *See* Ronald Alt, Sr. & Harley T. Duncan, *The Impact of Federal Changes on State Tax Systems*, 2 STATE TAX NOTES 308 (March 2, 1992).

[9] *See* Avi-Yonah, *Risk, Rents, and Regressivity,* 37 TAX NOTES INT'l 1651, 1665 (Jan. 10, 2005).

[10] Richard T. Ainsworth, *The Digital VAT (D-VAT)* 25 Virginia Tax Review 875, 883 n.16 (2006).

[11] *But see* Michael Keen & Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?* 59 NAT'L. TAX J. 861 & 885 (contending that "the current difficulties in the EU largely reflect circumstances that would not apply in the U.S. …and that the U.S. could to a large degree avoid if it were to move to a VAT, whether purely federal or with a state-level component too.")

[12] Richard T. Ainsworth, *The Digital VAT: A Proposal for the President's Advisory Panel on Federal Tax Reform* TAX NOTES 938 (August 22, 2005); and as fully developed at *supra* note 10.

[13] Richard T. Ainsworth, *Carousel Fraud in the EU: A Digital VAT Solution* 42 TAX NOTES INT'L 443 (May 1, 2006).

[14] Richard M. Bird, Jack Mintz & Thomas A. Wilson, *Coordinating Federal and Provincial Sales Taxes: Lessons from the Canadian Experience* 59 NAT'L TAX J. 889 (2006).

[15] The maximum coordination effort in Canada is never larger than 14 units of government (the federal government plus 10 provinces and 3 territories). In the EU it is a bit larger, involving 27 Member States. However, in the US the maximum effort would be to coordinate 7,588 discrete consumption tax jurisdictions (47 state level jurisdictions, including Washington, D.C. plus 1,732 counties, 5,571 cities, and 229 districts).

theoretical as well as a practical level, American tax professionals will be taking careful notes at the March 29, 2007 Conference on Fiscal Fraud – Tackling VAT Fraud: Possible Ways Forward. Seats are limited.

In a further article this column will consider the anticipated EU proposals for combating carousel fraud that are likely to be considered at this conference.