Europe struggles to come up with MTIC plan

Only a new VAT system in the EU will defeat missing trader intra-community fraud, believe John Benstead and Hassan Khan of the Khan Partnership

On September 2 2008, the European Parliament accepted a report on a coordinated strategy to improve the fight against fiscal fraud, issued by British MEP Sharon Bowles, (2008/2033(INI)). The motion in support of the report is strident in its language. The Parliament "calls" on member states to finally take the fight against fiscal fraud seriously; it "regrets" the blockading attitude of some member states; it "regrets" the council's failure to adopt an effective strategy against fiscal fraud; and it "urges" the commission not to desist from tackling the problem head-on.

It is worth putting the problem of missing trader intra-community (MTIC) fraud into perspective. Surprisingly, there are no definitive figures available as to the cost to the European taxpayer of value-added tax (VAT) fraud in general, let alone that attributable to MTIC fraud. This is because there are no consistent reporting standards operating across the Community. Estimates put total tax losses at e200 billion ($256 billion) to e500 billion ($640 billion), (or 2% to 2.5% of the EU's GDP).

Estimates for losses attributable to VAT fraud vary between e40 million and e60 million. In the UK, HM Revenue and Customs (HMRC) estimates that for the tax year 2005-2006 e18.2 billion was lost to VAT fraud and in 2006-2007, and the loss attributable to MTIC fraud to be in the region of £1 billion ($1.4 billion) to £2 billion ($2.8 billion).

The origins of the problem can be traced back to 1993 with the introduction of the internal market and, with it, the VAT system. The internal market with its free movement of persons, goods and services, by necessity required the introduction of a harmonised system of VAT across the community. The proposal was for an origin system, whereby VAT would be charged at the rate of the exporting member state.

As in many matters European, however, idealism was forced to make way to competing national interests. Member states were not prepared to cede their sovereignty to set tax rates. Instead, the "transitional" system was introduced which requires transactions to be taxed in the country of destination, in others words the opposite of the origin system. Value-added tax is accounted for at each stage of a transaction chain, so that as goods or services pass between registered entities, the supplier charges VAT, collects and remits it to the local tax authority. To counteract a distortion in competition, intra-community transactions are zero-rated.

The system works well enough when all the entities in a transaction account honestly for the VAT, but the zero-rating of cross-border transactions is the weak point in the system which is exploited by fraudsters. In MTIC fraud someone in the chain fails to pay the VAT by becoming a missing trader or by hijacking the identity of another company.

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Member states are individually taking action to stamp out MTIC fraud. In the UK, for example, a risk-based programme of extended verification on claims from businesses whose trade in goods is believed to be connected with MTIC fraud, (primarily mobile phones and computer chips), was introduced in March 2006. According to HM Treasury only 1% by value of the VAT withheld under this programme has been found to be properly repayable. If true, this gives weight to the UK government's assertion that MTIC fraud is out of control. The British tax authorities are facing significant litigation as a result of this programme and Treasury assertions as to levels of fraud should be treated with some caution. Nevertheless, as the Bowles Report notes, the scale of the problem is such that it cannot be solved at national level alone, especially given that much of the trade is cross-border.

Years-old problem

The question of how to tackle MTIC fraud is one which has vexed the EU at least as far back as 2000. By then it was clear that the VAT Information Exchange System, (VIES), set up with the introduction of the VAT system in 1993 was not working adequately. Commission proposals in 2001 for a new EC regulation to improve cooperation between member states were brought into force in January 2004 with Regulation (EC) No 1798/2003.

This consolidating regulation laid down binding rules requiring member states to exchange information in cases of suspected VAT fraud. Member states can also request information concerning taxable persons in other states. This is particularly useful in the context of MTIC fraud because it enables a national tax authority to check the authenticity of taxable persons in other member states.

Barely four months after the regulation came into force, the Commission in its report on the use of administrative cooperation arrangements in the fight against VAT fraud, (COM(2004)260), noted that there were still barriers to efficient administrative cooperation, in particular secrecy legislation which prevents some member states from transmitting information to other states. The report also noted that insufficient resources were being allocated by member states to deal with the increased cooperation arrangements.

The Commission noted in 2006, (COM (2006)0254), that while the framework offered by regulation 1798/2003 was satisfactory, member states were not making sufficient use of the possibilities offered by

John Benstead: A community clearing system would need to be established

it. In the same communication the Commission went on to consider what could be done to improve cooperation between member states. Member states were urged to make better use of the assistance offered by the Anti-Fraud Office (OLAF), and to adopt a multidisciplinary approach to the fight against fraud. It called on member states to take comparable measures against fraudsters, even where the tax loss occurs in another member state.

The communication concluded that the introduction of a definitive VAT regime could remedy the weaknesses in the system which has been exploited by fraudsters. The same communication also noted that the problem of fraud required political commitment on the part of member states if it was to be remedied. In effect the Commission was throwing down the gauntlet: by allowing national interests to take priority in 1993 they had created the problem and it was therefore incumbent on them now to solve it.

Possible solutions

In February 2008, the Commission issued another communication, (COM(2008) 109), on measures to change the VAT system to fight fraud, in response to an Ecofin request that the commission examine "far-reaching" measures to tackle VAT fraud. The commission looked at two issues:

- the taxation of intra-community transactions; and
- the introduction of a general reverse-charge system.

The taxation of intra-community transactions

If an origin system of VAT had been introduced, as intended,. with it would have come (as far as possible) a harmonisation of VAT rates across the community to avoid distortions of competition. Given that it is accepted that member states are no more willing to cede sovereignty today than they were in 1993, the Commission has proposed a system which requires little or no harmonisation of rates. Under its proposals, national VAT rates would remain, but intra-community supplies would be charged at 15% rather than 0%. Where a member state of arrival of goods applies a VAT rate more than 15%, the difference will accrue to that state. Where, however, a member state applies a rate lower than 15%, the member state of the purchaser will allow a credit to the taxable person making the acquisition.

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For the system to work, the Commission envisages that a community clearing system would need to be established to pass VAT among member states Apart from generalities, there are no detailed proposals on how the system would operate in practice. To work efficiently cooperation and reporting obligations between member states would need to be strengthened.

The Commission proposes that monthly recapitulative statements based on invoices issued and received would be necessary and member states would have to accept that as well as receiving payment from other member states that they would also need to make payments. Thus, in theory, there is a strong incentive for member states to cooperate and ensure the smooth functioning of the clearing system.

Ironically, however, this mutual dependency between member states is likely to be the biggest hurdle towards any implementation of a system of taxing intra-community transactions. The problem with the proposal is that there would be a net loss of revenue for those member states who import more goods from other member states than they export and, conversely, a net gain for those states with a trade surplus. So, there would be winners and losers.

According to the UK government, based on 2006 trade figures, it would lose e8.6billion ($11 billion) of VAT revenue. Given that we are told that in 2006-2007, the loss attributable to MTIC fraud in the UK was up to £2 billion ($2.8 billion), this proposal does not look like an attractive option.

The problem could be surmounted by setting up bilateral clearing houses between member states with roughly comparable trade figures, and this is being encouraged by the commission. As it is, however, it is probably unlikely that this proposal will be taken forward in this economic climate if there is the slightest possibility that a member state could lose revenue just when it is most needed to support a struggling domestic economy.

The reverse charge

The second proposal is for a generalised reverse charge. Under this system the person liable to account for the VAT is the purchaser of the goods or services rather than the supplier. The advantage is that, at a stroke, the opportunity to commit MTIC fraud disappears because input tax has to

be accounted for at each stage of the transaction chain.

The advantages of the reverse charge have led some member states, notably Germany and Austria, to obtain a derogation from the Sixth VAT Directive allowing the reverse charge for some transactions in its country. On June 1 2007 a temporary derogation came into force allowing the UK to impose a reverse charge in respect of mobile phones and computer chips.

It appears, however, that all the derogation has done is to migrate the fraud to other commodities such as metals and soft drinks. The derogation is temporary and will be reviewed in 2009 by which time the UK government will have had an opportunity to assess its impact.

On the face of it, a generalised reverse charge system would appear to be the solution to the problem of MTIC fraud but there are formidable arguments against its implementation. The biggest objection to a generalised reverse charge is that it offends against the VAT system which, although technically transitional, is likely to be with us for some time yet. Introducing a reverse charge on an optional basis for some goods would result in the creation of two parallel VAT systems which would hinder rather than encourage the implementation of a harmonised system across the community.

Introduction of a parallel reverse charge would increase the financial and administrative burden on businesses. In the first instance they would need to be able to identify those customers to whom the reverse charge applies and those to whom it does not and dual invoicing would be necessary. The local tax authorities would need to ensure that all the tools are available to enable businesses to be able to take a reasoned decision as to which invoicing regime applied.

There would also be additional reporting obligations placed on businesses to facilitate the cross-referencing of data by the authorities. This red tape would not be welcomed by either business or member states. It would be a barrier to improving European competitiveness and flies in the face of the EU's Lisbon Strategy, designed to improve jobs and growth and make Europe a more attractive place invest and work.

The reverse charge is also likely to spawn other forms of fraud. As a consumption tax, the person at the end of the chain would need to account for all the VAT rather, than as at present, on a fraction of it. There would therefore most probably be an increase in black market supplies. The net effect therefore would be to move the opportunity for fraud from the top of the supply chain, where it typically appears at present, down to the end of it. This is likely to result in an increased burden on national tax authorities, and on law enforcement agencies as they seek to tackle the black economy which will thrive from the change.

Hassan Khan: EU has been tackling MTIC fraud since 2000, at least"

A generalised reverse charge is therefore not the panacea it may at first seem but the Commission has not completely dismissed the idea. It has suggested that a pilot project be run in an interested member state. So far as the authors are aware, no member state has yet expressed an interest in participating in a pilot.

The Commission appears already to have admitted defeat. In its most recent communication of December 1 2008, (COM(2008)807), it noted that in the absence of political agreement on far reaching measures it had decided to concentrate its efforts exclusively on "conventional" measures to enhance the fight against tax fraud. These measures include

- common minimum standards for the registration and deregistration of taxable persons; enhancing cooperation with the creation of a new body to be called Eurofisc; and
- the extension of joint and several liability provisions to intra-community transactions.

One cannot help but think that we have been here before.

The Commission also proposes amending the VAT Directive by tightening the conditions under which the importer of goods can seek an exemption from VAT. First, the importer will need to be identified for VAT purposes, he will also be required to both communicate the VAT registration number of the person in another member state to whom the goods are to be sold and prove that the goods have been dispatched to another member state. Secondly, the supplier will be held liable for a VAT loss caused if his customer becomes a missing trader in another member state when the supplier contributed to the loss by failing to report, or inadequately reporting the supply to his local VAT office.

Flaws

On the whole, these two proposals are welcome additions to the EU's armoury; however they cannot disguise the fact that they are no substitute for the introduction of a definitive VAT system.

The frustration of the European Parliament is understandable but there is no magic bullet which will slay the problem of MTIC fraud. The two possible solutions on offer have serious disadvantages which raise the question of whether they can ever be serious contenders. Of the two, the reverse charge probably offers a realistic solution within the VAT framework but the challenge will be to persuade business, which will be most affected by it.

Overall, the origin system provides the best solution to tackle MTIC fraud across the EU. Until, however, member states are prepared to embrace a truly harmonised VAT system across the community their protestations about the need to tackle MTIC fraud have a hollow ring about them.

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