COMBATING VAT FRAUD IN THE EU

THE WAY FORWARD

INTERNATIONAL VAT ASSOCIATION

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Table of Contents

EXECUTIVE SUMMARY 4
INTRODUCTION 6
THE EUROPEAN VAT SYSTEM 10
SOLUTIONS CAPABLE OF REDUCING VAT FRAUD 15
INSPECTION AND CONTROL MEASURES 31
COOPERATION BETWEEN REVENUE SERVICES 40
CONCLUSION 43
APPENDICES 46

EXECUTIVE SUMMARY

European VAT fraud is growing at an alarming rate – both in its quantum and its level of sophistication - to the point that it is today beginning to affect the accuracy of Member states' trade statistics. Estimates vary concerning the actual level of VAT losses, with figures ranging from €60bn - €100bn per annum for all Member states. Whatever the actual level of fraud, these figures highlight the urgent need for Europe to address the issue of the reform of the VAT system. What shape that reform should take is the subject of this paper.

The suppression of fiscal borders in the EU has allowed businesses to purchase goods and services cross-border without being charged VAT. This is the source of much of the missing trader intra-community (MTIC) fraud, or "carousel" fraud, predominantly achieved using mobile telephones and computer chips as a conduit to facilitate the fraud.

Whilst Member states are fighting hard to stop this activity, VAT fraud has become an established industry. New innovative forms of fraud are constantly under development – with the most sophisticated new variants of MTIC fraud incorporating the purchase of cross-border services to defraud National Treasuries. This latest move assists the fraud because services by their very nature are intangible, and more difficult for tax administrations to police.

In a bid to tackle these issues, a number of Member states have already introduced their own "solutions". One such example includes the application of the reverse-charge to the supply of goods and services in France by a non-established supplier, with effect from 1 September 2006. More recently, Germany and Austria have sought dispensation by way of derogation from the VAT Directive 2006/112/EC to apply a generalised reverse-charge to domestic B2B transactions, effectively shifting the application of the tax to the retail phase. The UK has also applied for a similar derogation, but has confined its scope to specific supplies of goods.

Whilst the motivations behind these changes focus on addressing VAT fraud, it is regrettable that to date the solutions put forward by Member states, appear to have been drawn up without significant levels of coordination. This lack of coherence and coordination reduces the effectiveness of the measures, places an extreme burden on legitimate businesses and acts to the detriment of Europe's competitiveness as a whole.

This report analyses a number of options for addressing the current haemorrhaging of Europe's VAT system and draws the following key conclusions:

1. Moving away from today's fractionated payment system to a sales-tax approach based on the "reverse-charge" mechanism would multiply the potential sources of tax evasion in the

EU. The assumption that such a fundamental change to Europe's VAT system holds the key to combating VAT fraud must, in our view be seriously challenged.

2. The existing 'transitional' VAT system, despite its flaws, has contributed effectively to the collection of a broad-based consumption tax. To strengthen the current system, Member states must act in a coordinated manner and resist the temptation for unilateralism. Failure to do so will lead to more complexity and fragmentation, place new burdens on legitimate business and further stimulate fraud.

3. Europe's first priority should be to strengthen fiscal cooperation between Member states. Information-sharing and coordinated action form the backbone of Europe's VAT enforcement provisions. This remains the priority, however, Europe's VAT architecture evolves over time

4. Supporting this, Member states' administrations should consider establishing a multi-jurisdictional, VAT enforcement unit. The unit would require an adequate level of resources and incentives to overcome the endemic inertia of national administrations to tackling VAT losses in other Member states.

5. Member states' administrations working with businesses should be able to determine how, through the use of new technologies the opportunities for fraud can be significantly reduced – whether through transaction tracking or more rapid exchanges of information. The improvement of the VIES system is a critical component of this strategy.

6. The use of traditional measures to combat fraud – which include subjecting new VAT registrations, refund claims and a sample of intra-EU traffic flows to additional checks – should be approached in a more coordinated and consistent fashion across all jurisdictions. The disproportionate use of such controls, concentrated in a few Member states, harms the legitimate taxpayer whilst 'transporting' the problem to other jurisdictions.

7. Any move to a 'country-of-origin' principle, which should provide the best VAT system for Europe's Single Market, is fraught with political challenges. Notwithstanding this fact, there are significant benefits to be obtained in the fight against VAT fraud, in exploring the notion of a 'hybrid' system between the origin and transitional systems of today. This would be pursued via the application of a standard EU-based tax on intra-EU supplies, possibly at a standard rate of 10% - sufficient to reduce the incentive of carousel fraud.

8. Finally, Europe is witnessing a rise in fraud using the reverse charge mechanism applied to cross-border supplies of services. The increasingly sophisticated fraud industry, in a bid to counteract new enforcement controls over goods, is leveraging services as a new tool to expand their industry. Proposed solutions to Europe's VAT dilemma must take account of this growing phenomenon.

INTRODUCTION

The purpose of this paper is to contribute to the debate on the ways in which Europe can fight against the increasing burden and cost to Member states, and to legitimate taxpayers, of VAT fraud.

The International VAT Association (IVA) is the world's leading body on international VAT issues, representing the interests of businesses and advisers involved in VAT or equivalent turnover taxes around the globe. In Europe, the IVA's membership is represented in all 27 EU Member states. Globally, the Association covers all major international markets. This paper seeks to offer the IVA's international perspective on Europe's ongoing VAT fraud debate.

In pursuing VAT fraud, it is clear that there is no one solution which will balance the legitimate requirements of taxing authorities and those of taxpayers and it is conceivable that any solution adopted will be a "least bad" solution rather than the best one. What is clear is that the existing situation of substantial and increasing levels of fraud is not sustainable – although Member states may have, at least in the short term, found solutions to certain types of fraud by effectively stopping all refunds of VAT – clearly a long term solution needs to be found.

This report reviews a range of possible solutions: in the field of the increased use of technology to allow real-time declarations of transactions; via VAT returns or the VIES system; additional administrative cooperation or "simply" a fundamental change to the whole of the EU VAT system. As more and more countries adopt Europe's invoice-based VAT system, the issues related to fraud are being addressed at implementation stage and a number of innovative solutions being tried. Further work may be required in this area to determine the overall effectiveness of each proposed solution, and their adaptability to a developed economy such as that within the EU.

MAIN SOURCES OF VAT FRAUD

This paper acknowledges the main sources of VAT fraud encountered in the EU, as enumerated by the European Commission[1]:

- The black economy;
- Insolvencies;
- Missing trader fraud – including "carousel" type fraud;
- Other types of fraud.

[1] Commission Working Paper TAXUD/1804/06

Estimates vary concerning the actual level of VAT fraud in the EU, with figures ranging from €60bn[2] - €100bn[3]. Whatever the actual level of fraud, these figures highlight the urgent need to address the issue of VAT reform.

The black economy

The black economy is a sizeable hidden section of the economy in which private cash transactions go unreported, escaping VAT altogether. It is estimated that the black economy may account for up to 30% of GDP in some Member states.

Insolvencies

These can be deliberate or as a consequence of adverse financial circumstances, where the supplier of the goods/services never accounts for the tax he has collected from his customer (due to his insolvency) and which the VAT identified customer then recovers.

Missing trader fraud

This type of fraud works on the following basis: taxpayer A charges VAT to taxpayer B and A never accounts for the VAT paid to it by B. B recovers the VAT paid to A on its VAT return. The recent cases of Bond House Systems Ltd, Optigen Ltd, Fulcrum Electronics Ltd and Axel Kittel at the European Court of Justice[4], have addressed some of the issues, but a significant number of problems persist. According to the UK authorities, the level of fraud of this type is about € 750 million per month at present in the UK alone.

The following illustration shows a typical Missing Trader type fraud structure involving two Member states, so that 'B' in the illustration can purchase goods VAT free.

Whilst traditionally limited to the supply of goods (most notably mobile phones and computer microchips), there is nothing to stop this type of fraud, in principle, being conducted using supplies of services that are subject to the reverse-charge when purchased cross-border. By virtue of their intangible nature, services are more difficult to track, and do not require the same level of VAT reporting as supplies of goods.

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[1] Commission Working Paper TAXUD/1804/06

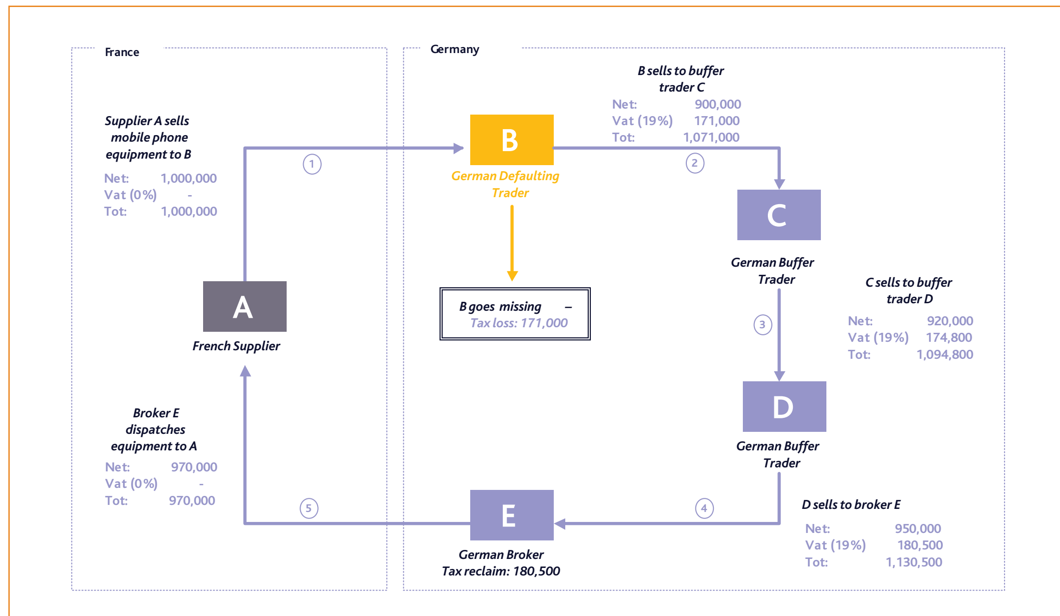
[2] Commissioner Lazlo Kovac comments on the adoption of "European strategy to combat tax fraud", 31 May 2006.

[3] "VAT fraud in the European Union", The Economist, 11 May 2006.

[4] C-354/03 OptigenLtd, C-355/03 Fulcrum Electronics Ltd, C-484/03 Bond House Systems Ltd and C-439/04 Axel Kittel

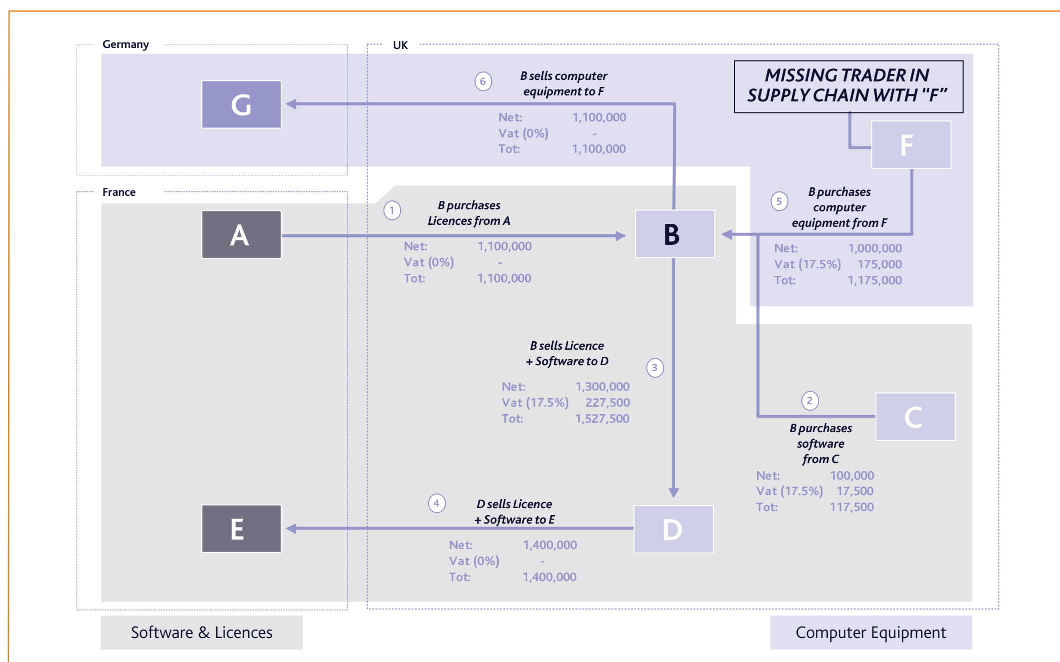
[5] Article 56(1) of Directive 2006/112/EC (formerly Article 9(2)(e) of the 6th Directive - 77/388/EEC), which includes, inter alia the following types of services: licenses, advertising, professional and consultancy services, telecommunication services, radio and television broadcasting, etc

Figure 1 | **Illustration of a simple Missing Trader, Intra-Community Fraud (MTIC)**



Furthermore, as National authorities have sought to break carousel-type fraud chains through actively blocking refund claims, the fraud industry has developed new strategies to "mask" their fraudulent activities, by actively exploiting the reverse-charge mechanism where it applies to cross-border supplies of services[5], as illustrated in the below diagram.

Figure 2 | **llustration of a complex Missing Trader, Intra-Community Fraud (MTIC) involving services**



[5] Article 56(1) of Directive 2006/112/EC (formerly Article 9(2)(e) of the 6th Directive - 77/388/EEC), which includes, inter alia the following types of services: licenses, advertising, professional and consultancy services, telecommunication services, radio and television broadcasting, etc

In the above illustration, the fraud is perpetrated through the following connected transactions, by a series of entities complicit in the fraud:

1) Software licences are purchased by 'B', from a company, 'A', based in another EU Member state. As both companies are registered for VAT in their respective countries - and the software licences supplied are a category of service which is subject to the reverse-charge mechanism for cross-border supplies - the licences are effectively purchased 'VAT-free' by 'B'.
2) 'B' subsequently enters into a domestic transaction and purchases software from 'C', who is VAT registered in the UK. 'B' pays VAT on this transaction of £17,500.
3) The licences (purchased from A) and the software covered by the licences (purchased from C) are subsequently sold by 'B' to another UK VAT-registered customer, 'D'. 'B' collects VAT on its supply to 'D' to the amount of £227,500.
4) 'D' then sells the licences and software to a customer based outside of the EU. This transaction is subject to the reverse-charge (similar to Step 1) and no VAT is charged. 'D' then files for a repayment claim from the UK.
5) As a totally separate and unconnected transaction, 'B' also purchases large quantities of goods (typically mobile handsets) from 'F,' which are subject to VAT. 'B' pays the VAT of £175,000 relating to this transaction. Somewhere in the supply chain connected to 'F' there is a missing trader – within a connected process flow similar to that described in Fig 1, above.
6) 'B' then sells this equipment to a customer based in another Member state, which, too, will be subject to the reverse-charge.

The net result of this (more complex) example, is that 'B' is used as a conduit to facilitate and mask carousel fraud being committed in the supply chain with F. This is done by using the purchase of cross-border services (in this case, licences) to 'neutralise' the VAT returns of 'B', who will end up making a small repayment to the UK representing the difference between his input and his output VAT of £35,000.

When 'D' files for his repayment claim of £227,500 from the UK, it does not raise particular suspicions or enquiries from the Revenue services for the following reasons:

- 'D' is not involved in the sale or purchase of goods and can claim no knowledge of the missing trader in the supply chain connected to 'F'
- 'B's VAT returns appear normal, with a net payment of VAT being made to the UK authorities of £35,000 (ie £227 500 of VAT collected less £175,000 of input VAT paid to 'F' and £17,500 of input VAT paid to 'C').

At present, such frauds are perpetrated by "importers" who associate the purchase of the services with a separate purchase involving a chain of supply, generally of goods, where there are tax losses.

If the principle of applying the reverse-charge mechanism is extended to other services, as currently proposed by the Commission, it will not only expand opportunities for MTIC fraud in services themselves, but also expand the opportunities for arranging fraud-masking operations similar to the model set out above.

Other types of fraud

The Commission listed two other types of fraud:

- Invalid deductions of input tax – false input tax invoices, or goods/services obtained for non-business use. There are many variants of this type of fraud.
- Non-payment of output tax, including sales at lower than normal values. Again there are many variants.

This paper focuses on combating two of the largest types of fraud listed above - "Missing Trader" and "Deliberate Insolvencies".

THE EUROPEAN VAT SYSTEM

In order to have a full understanding of the impact of the different types of fraud and the possible solutions that are available to Member states, it is important to consider the essential characteristics of the EU VAT system to appreciate how the different types of fraud operate.

A brief history of key VAT developments within the EU is included in Appendix 1.

BACKGROUND

"La plus grande innovation fiscale du XXème siècle" ("The greatest tax invention of the 20th Century")[6], VAT is a consumption tax whose notoriety comes from its inherent characteristics: a high-yield tax imposed on a good or service at each stage of the economic cycle, economically neutral in terms of the length of the production chain and levied indirectly[7] on spending[8].

[6] G. Egret.

[7] According to a technical classification that uses the administrative arrangements and methods of taxation as criteria, VAT is an indirect tax: the taxable person paying the tax to the government is any person involved in the supply of the good or service at whatever stage, as well as the final consumer who is actually liable for the tax.

[8] According to a classification based on the economic elements taxed (income, expenditure and capital), VAT is a tax on spending. The basis of taxation is consumption. This is because VAT does not tax all added value. On the one hand, it exempts that part of added value incorporated into business investments and exports of goods and services, in addition to part of the added value of public administrations. On the other hand, it taxes the added value generated in other countries and incorporated into imports.

Taxes on spending include VAT and Excise duties (a term used in European law to designate a category of spending tax that applies to the consumption of certain products, such as alcohols).

Because of its characteristics, in particular that it is collected in stages and that it does not create distortions of competition in international (ie non-EU) trade, VAT has been adopted by the EU as well as by a significant number of other countries around the world.

According to the International Monetary Fund (IMF)[9], at the beginning of this decade, around 118 countries had introduced a VAT-type tax, with the only remaining notable exception being the United States[10]. Today, the United States is still the only OECD country without a VAT system[11].

Despite the advantages of taxing consumption using a VAT system, in a common market, this systematic taxation on a domestic basis does not reflect fully the interactions with international trade and is liable to affect competition between Member states on intra-EU trade[12]. In fact, the Tinbergen report (1953) observed that disparities in the domestic taxation of Member states partly – if not totally – prevented a common market from being established. Consequently, harmonisation of the domestic tax systems of these States was a necessary step for the creation of the common market.

DEFINITIVE SYSTEM – THE ORIGIN PRINCIPLE

The Treaty of Rome (1957) provided a new incentive for the harmonisation of business taxes, calling for the approximation of laws in the signatory countries. Technical studies were carried out by working parties, among them the Fiscal and Financial Committee chaired by Professor Neumark.

According to the Neumark report (1962), Member states first had to adopt a general turnover tax similar to VAT. They then had to abandon, for intra-Community transactions, the taxation of products in the country of destination in favour of taxation in the country of origin, since this would help abolish tax barriers without distorting competition. This report became the cornerstone of the country of origin principle and the first two EEC (EU) VAT Directives.

The first two VAT Directives of 11 April 1967 introduced a Community-wide VAT system. In addition, these directives established the principles and fundamental concepts of VAT in terms of scope, taxable event, basis of assessment, exemptions, deductions and taxpayers' obligations. However, the introduction of a VAT system common to all Member states did not take place until 1978, with tax barriers being abolished only in 1993.

These first two directives, now repealed by Directive 2006/112/EC, enshrined the legal and political commitment of the Commission and Member states to set up a common VAT system

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[9] XIXème Rapport au Président de la République relatif à la TVA, Conseil des Impôts, June 2001.

[10] The United States charges final consumers a sales tax. This is a tax on retail sales levied at a single point: consumption

[11] Consumption Tax Trends, OECD, 2004.

[12] In the case of the European Union, before the abolition of border controls, the effects on competition were offset by customs clearing. Imports were taxed on entry to ensure that foreign goods would be under the same fiscal pressure as domestic merchandise.

in which the taxation of imports and the zero-rating of intra-community exports would be abolished in favour of taxation of goods and services in the Member state of origin - which would become the "definitive system".

THE SIXTH DIRECTIVE

The Sixth VAT Directive of 6 May 1977 standardised the basis of the application of VAT on supplies of goods and services within the EU, whilst taking account of the aims of the Common market and the abolition of tax frontiers. Nevertheless, it has not been possible to harmonise rates and the significant numbers of derogations in terms of exemptions.

In 1985, the Single European Act set a deadline of 31 December 1992 for the abolition of internal borders. This meant that to abolish tax frontiers[13], further harmonisation would be needed beyond that provided by the Sixth Directive. VAT rates had to be harmonised in order to introduce a clearing system, so that VAT collected in the country of origin could be returned to the country of consumption and that abolition of competition is minimised.

In 1987, the Commission tabled a proposal aimed at introducing a VAT system adapted to the internal market, operating within the European Union in the same way as within a single country, resulting in taxation in the country of origin. The system respected the fractionated payments mechanism and provided a clearing system to ensure that VAT collected in the "exporting" Member state and deducted in the "importing" Member state would be repaid to the latter[14].

However, this proposal was rejected by the Council for several reasons, including the following:

- The clearing mechanisms proposed by the Commission were considered ineffective and difficult to manage, since the tax administration that had to carry out the checks on deductible VAT was not the one in the country "profiting" from the tax[15].
- The harmonisation of rates was a *sine qua non* of the definitive system, causing Member states to lose their autonomy in deciding VAT rates. This meant that it would be difficult for Member states to use VAT rates for budgetary purposes[16], causing them to sacrifice part of their fiscal sovereignty. Germany for example would not have been able to increase its VAT recently by three points if harmonisation of rates hade been introduced.

The political will of the Member States to embrace the plans for the definitive system was thus inevitably lacking.

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[13] The effective zero-rating of exported products and the taxation of imported products.

[14] It is essential that the tax is returned to the country of consumption: VAT is a consumption tax and is paid by the final consumer. It is only right therefore that VAT receipts should return to the country where consumption takes place.

[15] This kind of system has the disadvantage of disconnecting the tax collected in a country from the tax receipts of that country, hence the lack of incentive for the domestic tax authorities to enforce the tax legislation of the country of consumption.

[16] For example to increase the rate of VAT to cover budget deficits.

THE TRANSITIONAL SYSTEM AND THE REMOVAL OF FISCAL BOUNDARIES

Despite this, the ECOFIN Council adopted a "transitional" system which would allow internal border controls in the EC to be abolished in 1993, without the need for the close harmonisation of rates, whilst allowing the destination Member state to continue collecting taxes. This "transitional" system was to be replaced by the "definitive" system in 1997; however, it still remains in force to this day.

In the transitional system (i.e. the system still in existence), transactions are taxed in the country of destination. To avoid distorting competition and relocation due to the absence of rate harmonisation, intra-community transactions are zero-rated for the supplier and are taxed at the point of destination via the reverse-charge mechanism. Tax neutrality is guaranteed by continuing to grant the supplier the right to deduct input VAT.

THE RISE OF VAT FRAUD

This exemption, (effectively zero-rating of cross border transactions) inherent in the transitional system, is a weak point of the system and is being clearly exploited by fraudsters, via one of the types of VAT fraud called "carousel fraud".

Although VAT fraud has always existed, the current levels of fraud are giving rise to increasing concern. It was recently estimated that EU Member states suffered a combined annual loss of around €100 billion[17] per year. These estimates are calculated based on the difference between theoretical VAT receipts and actual receipts, since only Germany and the UK have the data officially published. This loss of revenue is attributed to a variety of factors, such as tax evasion, business insolvency, basic errors and fraud.

In addition to tax losses, fraud is a major factor in the distortion of the Common market due to the unfair competition it causes. The Commission, to safeguard the operation of the Internal Market and to protect the financial interests of the European Union, is working on the development of a coordinated strategy to tackle tax fraud, despite the fact that the areas of control over taxable persons, organisation of tax administrations and tax recovery are the responsibility of Member states.

THE FIGHT AGAINST VAT FRAUD

Several measures have been proposed to the European Commission to assist in the fight against VAT fraud, notably adjustments to the current tax system, a general reverse-charge

[17] "A tax net full of holes – VAT fraud in the European Union", The Economist Newspaper, London, 13 May 2006.

mechanism, the implementation of the definitive VAT system and other possible solutions to prevent fraud or tax evasion.

The difficulty is that any measures designed to tackle VAT fraud must respect the fundamental principles adopted by the European Union. These can be listed as follows:

- The formation of a Common Market.
- Fair competition.
- The prohibition of measures that prevent the free circulation of goods, services, people and capital.

And the specific VAT principles enshrined in the First VAT directive:

- The creation of a single VAT system.
- Neutral in terms of the origin of the good or service and the length of the transaction chain.
- Applicable at all stages of production and distribution, including retail.
- Proportional to the price of the goods and services.
- Charged based on a non-aggregate system where input tax is deductible from output tax.

Whilst not enshrined in the VAT Directives, it is clear that the simplicity of any tax system reduces the cost of complying with tax regulations for companies and is therefore cost-effective and less likely to generate errors and mistakes, if not fraud.

The OECD revealed that *"the tax authorities of the (OECD) countries are ready to rise to the challenge of globalisation in the interests of the citizen"*. Amongst these challenges, the OECD lists *"the improvement of the efficiency of administrations and a reduction in the cost of complying with tax regulations for companies, while reducing the possibilities of fraud and tax evasion."*[18].

The European Commission is also committed to this policy. It maintains that the fight against tax fraud is part of the broader context of the achievement of the Lisbon objectives, and that *"the simplification of the fiscal environment is a key aspect of this policy. The measures envisaged to tackle fraud more effectively cannot run counter to this objective."*[19]

A fundamental question that must be asked is whether it is possible to reduce fraud without increasing the administrative burden on taxpayers responsible for complying with the associated tax regulations.

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[18] OECD Consumption Tax Trends, OECD, Paris, 2004, 120 p.

[18] OECD Consumption Tax Trends, OECD, Paris, 2004, 120 p.

[19] COM(2006)254 final.

Finally, **a balance must be struck** between measures to tackle tax fraud and the basic VAT principles, particularly the principles of **legal security, legitimate expectation and proportionality**.

SOLUTIONS CAPABLE OF REDUCING VAT FRAUD

According to the Commission[20], the preconditions for any change to the current VAT system are that they have to:

- reduce considerably the possibilities for fraud and **exclude new important fraud risks**,
- generate no **disproportionate administrative burdens** for traders and the authorities,
- ensure tax **neutrality**,
- ensure **non-discriminatory** treatment in a Member state between both national operators and operators established elsewhere.

In assessing the advantages and disadvantages of each solution, we will also refer to the above preconditions as laid out by the Commission.

1. COUNTRY OF ORIGIN VS COUNTRY OF DESTINATION

Since 1962, the European Commission has maintained that the adoption of the country of origin system, i.e. the taxation of all goods and services in the country where the supplier is established, is the best solution for the Single Market.

The effect would be that a supplier in a Member state would apply the same rules and rates whether his customer was in the same Member state as himself or in a different one. The supplier would no longer be required to determine the taxable status of his customer, nor retain documents to prove the movements of goods etc.

The following diagrams provide a simple illustration of the differences in VAT treatment between taxation at point of origin vs destination. For the purposes of simplicity, a VAT rate of 10% has been applied to a connected set of transactions between a manufacturer 'A' who sells goods domestically to a distributor 'B' in Member state 1, who in turn sells to a distributor 'C' in Member state 2. 'C's onward sales will be to final consumers.

[20] Communication from The Commission to The Council, The European Parliament and The European Economic and Social Committee concerning the need to develop a co-ordinated strategy to improve the fight against fiscal fraud, COM 2006 (254) FINAL.

Figure 3 | **Origin principle**

	Member State '1'			Member State '2'	
	A	B		C	
	Sells	*Buys*	*Sells*	*Buys*	*Sells*
PRICE	100 →	100	200 →	200	300
VAT (10%)	+10	-10	+20	-20	+30
NET VAT	+10	+10		+10	
TAX REVENUE	+20			+10	
TAX AFTER CLEARING	→			+30	

Source: 'Options for a definitive VAT system', European Parliament, September 1995

Under the country-of-origin system, the sale from 'B' to 'C' would be treated no differently to a domestic transaction, with the transaction subject to VAT at the rate of Member state 1. The 30 units of tax is now effectively split between Member states 1 and 2, however this tax would then be reallocated from Member state 1 to Member state 2 (where the goods are sold to ultimate consumers) through a centralised "clearing system" so tax revenues amounting to 30 units accrue to Member state 2.

Figure 4 | **Destination principle**

	Member State '1'			Member State '2'	
	A	B		C	
	Sells	*Buys*	*Sells*	*Buys*	*Sells*
PRICE	100 →	100	200 →	200	300
VAT (10%)	+10	-10	0		+30
NET VAT	+10	-10		+30	
TAX REVENUE	0			+30	

Source: 'Options for a definitive VAT system', European Parliament, September 1995

Under the destination principle, the sale of goods from 'B' to 'C' are effectively de-taxed, and 'B' will seek a repayment of 10 units of input VAT that he has paid to 'A'. The net effect in Member state 1 is a neutral position for VAT purposes, as all 'value' have been transferred to Member state 2. 'C' will in turn account for VAT on his subsequent sales, with the net effect of taxation of 30 units in Member state 2 on subsequent sales to local consumers.

At the time when border controls were abolished in 1993, the lack of political will to adopt the "origin" system proposed by the Commission led to the "transitional" adoption of a destination-based tax system.

Despite the fact that taxation in the country of origin has always remained the norm, the "transitional" system has been adjusted over the years in a bid to eliminate distortion of competition, tax evasion and fraud, without ever going as far as adopting the country of origin system.

In the 21st century, what are the advantages and disadvantages of taxation in the country of origin when it comes to tackling VAT fraud? Is it in effect a real "solution"?

Taxation in the country of origin was proposed by the Neumark report in 1962. At that time, this was the only system that would have allowed the creation of a Common Market being subject to the same conditions as a domestic market without distorting competition, whilst anticipating the abolition of border controls. However, to achieve that objective, further harmonisation would be required between national legislations in particular as regards VAT rates.

Taxation in the country of origin still has its appeal on the grounds of simplicity - if nothing else - despite the fact that the transitional system is effectively a mixed system: with certain transactions being taxed in the country of origin and others in the country of destination.

The Commission[21] is of the opinion that the origin-based method of taxation, with the transfer of receipts to the country of destination, would be effective in reducing at least certain types of VAT fraud.

Advantages

- The end of zero-rated intra-community supplies and thus an end to the financial benefits of carousel fraud.
- The simplicity of the system. A simple taxation system allows the operator to be certain in advance of how much tax should be charged to the customer. Simplicity is the corollary of the principle of legal security and legitimate expectation. Simplicity encourages the voluntary payment of tax, which reduces the costs of its recovery.
- The reduction of the cost of complying with tax regulations for companies. Taxation in the country of origin allows the economic operator to deal with a single tax administration, a single VAT registration and a single interpretation of the law, facilitating access by small businesses to the intra-community market.

[21] Drastic EU plan to fight €60bn VAT fraud", Financial Times, Europe, 29 May 2006.

- The return to the system of taxation at all stages of the production, distribution and service provision cycles, as recommended by the First VAT directive (now Directive 2006/112/EC).

Disadvantages

- The need to develop an effective system of reallocation of receipts obtained in the country of origin to the country of destination/consumption:
  - This reallocation system must take account of the economic transactions actually made by taxable persons in the country of destination, rather than the reallocation of receipts based on macro- or micro-economic criteria,
  - The system should effectively require the direct payment of receipts by the taxpayer to the country of destination.
- The implementation of the "definitive" system would give rise to additional costs for businesses. However, this should, in the view of the IVA, be acceptable provided that it is accompanied by a reduction in the costs of compliance for business in dealing with the tax regulations.
- The greatest disadvantage of this tax system is the loss of tax sovereignty for the Member states. In this tax system, Member states can no longer increase or reduce their VAT rates for fear of losing "business" to other Member states (although the VAT receipts will be reallocated back to the Member state of consumption). Nevertheless, this loss of sovereignty may be mitigated if Member states are still able to increase or reduce their VAT rate by 1 or 2%, as can be successfully seen in France with the floating rate of excise duty on petrol (TIPP) between départements.

In fact, "The Commission has always maintained that a differential rate between Member states of 1 or 2 percentage points would not impact on the operation of an origin system, but the current spread of 10% in the standard rate is significant and it is unlikely that this differential could be reduced even in the mid term. Moreover, reduced rates are optional and the entire picture is complicated by the multiplicity of derogations granted to some Member states; derogations which appear non-negotiable"[22]

Conclusion

It is the opinion of the IVA that, whilst the principles of the definitive regime are best suited for the Single Market, the obstacles preventing political consensus on aligning VAT rates and redistributing funds, remain too great. In 1997, at the time when the principle of the single currency had just been adopted, although not implemented, the adoption of the definitive VAT regime in addition to the Euro was just a step too far for Member states.

[22] The European Commission, VAT Strategy 2006-2011, Brussels, 27 October 2005, p. 4.

Nowadays, despite the advantages of the system for tackling certain types of VAT fraud, it seems that Member states will not reach political consensus for taxation in the country of origin.

2. MODIFYING THE 'TRANSITIONAL' SYSTEM

Since the elimination of tax frontiers in 1993, the "transitional" system of taxation in the country of destination has proven to be the best political compromise possible.

Over the years, adjustments have been made to the transitional system to make up for its flaws. The current challenge is to determine whether it can be developed with the objective of reducing VAT fraud.

Several measures at European level or at the level of the Member states have thus been taken in recent times to prevent and reduce tax fraud:

- Targeted application of the reverse-charge mechanism for some specific sectors such as construction work, waste delivery, etc[23].
- The use of the "normal value" as the basis for taxation for transactions between related entities[24].
- Application of the reverse-charge mechanism in transactions with taxable persons not established in the country of taxation[25].
- Considering jointly and severally liable the taxable person who knew or had good reason to suspect that all or a portion of the VAT due would not be paid to the State[26].

One of the objectives of these measures is to reinforce the legal means enabling Member states to fight fraud in a more efficient manner. *A fortiori,* they come within the framework recently determined by the jurisprudence of the Court of Justice of the European Communities (ECJ), in particular the Optigen[27], Federation of Technological Industries (FTI)[28] and Halifax judgments[29] .

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[23] Council Directive 2006/69/EC of 24 July 2006.

[24] Ibidem.

[25] Article 194 Directive 2006/112/EC

[26] Article 93 Rectifying Finance Law 2006 – France. Similar measures exist already in the UK and Germany.

[27] Judgment of the ECJ of 12 January 2006 *Optigen Ltd, Fulcrum Electronis Ltd, Bond House Systems Ltd vs Commissioners of Customs & Excise.*

[28] Judgment of the ECJ of 11 March 2006 *Commissioners of Customs & Excise vs Federation of Technological Industries.*

[29] Judgment of the ECJ of 21 February 2006 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd vs Commissioners of Customs & Excise*

Advantages

The benefits of maintaining the "transitional" system but further developed in order to fight fraud are the following:

- Maintaining the Member states' sovereignty concerning VAT rates and other measures that are not harmonised.
- Goods and services generally bear the tax burden of the country where they are consumed.
- From the perspective of fiscal receipts, taxation in the country of destination is in keeping with the territorial competence of the revenue authorities to which the receipts belong *a fortiori*.
- It has proved a great improvement in suppressing the formalities that were previously required when goods crossed borders, without the need to harmonise VAT rates and rules on input tax deduction.

Disadvantages

The disadvantages of modifying the "transitional" system - even if it were to be further developed:

- **Reduction of the economic efficiency of European companies.** The new measures being adopted in a "piece meal" manner by Member states, cause a considerable increase in companies' administrative costs, in particular with regard to the burden of proof of their good faith with respect to transactions they undertake.

  This, combined with the already high costs they bear to operate in the intra-community market (registration in each Member state, the various interpretations of the same legal provisions, etc.), has a negative impact on consumer prices, employment, company efficiency, the choice of a company's place of establishment, which together impacts the international competitiveness of European business.

- **Increasing complexity of the system instead of simplification thereof.** This is clearly contrary to the global policies of the OECD concerning the application of VAT, the Lisbon Strategy[30], the political commitment established by the Commission when defining its strategy to fight fraud[31] and the principles laid down by the First VAT Directive.
- The measures required to fight fraud prove to be contrary to or at best in the 'grey zone' as regards respecting the general principles of law that are part of the Community legal system, including in particular the principles of legal certainty and proportionality. There is also a discriminatory element in relation to non-established taxpayers who, arguably, have a different set of rules with which to comply.

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[30] COM(2005)532 final

[31] COM(2006)254 final

- There is a transfer to taxable persons of the activities which, *a priori*, should be conducted by the revenue services. It is true that taxable persons must have a part to play in the fight against fraud, but they should not be put in the position of guarantors of fiscal receipts that were not declared by the person legally liable, on the basis that there is a presumption of fraud. That undermines the presumption of innocence, freedom of establishment, the principle of non-involvement in the management of the company and other rights established by the European Convention on Human Rights (ECHR).

- Intra-community transactions are still exempt, and carrousel fraud thus remains possible. The above-mentioned measures are only expensive "stopgap" measures.

- The transactions carried out by a taxable person in a Member state other than the one where he is established are not as effectively monitored by the Revenue services of his "home" country. This weakness of the system is exploited by persons who commit fraud because the (Community and international) cooperation agreements are not yet sufficiently effective.

- Considering the territorial competence of the Revenue services, they are more interested in carrying out their audit activities in order to increase the budget of their own State even if they are to the detriment of tax receipts in another Member state.

Conclusion

There is no doubt that the transitional system has proven to be a great improvement in suppressing the formalities that were previously required when goods crossed borders. For businesses, it has meant a considerable reduction in costs related to the movement of goods, suppression of delays and forwarding costs, allowing EU businesses to become more competitive.

However, this system, which was only intended to remain in place for four years, has led to an explosion in the levels of VAT fraud, with fraudsters using devious methods of exploiting the one area where the transitional system deviates most from the fundamental principles of the original VAT system – that of fractionated payments. We have seen how the ability to purchase goods (and now potentially services), 'tax free' across borders has created the financial incentive to perpetrate 'carousel' type frauds.

It is hardly surprising, therefore, that Member states have attempted to find 'stop-gap' solutions either within the existing Directives (by making another person, other than the supplier liable for the tax due) or by requesting and obtaining derogations similar to what the UK, Germany and Austria have applied for. Whilst these unilateral actions may stem the kinds

of fraud associated with the existing weaknesses in the transitional system, it is unknown how the fraud will 'evolve' and whether new, important fraud risks will develop.

It would be regrettable to abolish such a system (the current transitional system) at this stage and would be viewed by businesses as a retrograde step. What needs to be achieved is a mechanism for improving the system to combat fraud – not on a piece-meal basis, but through a coordinated approach involving all Member states.

3. REVERSE-CHARGE

The fiscal mechanisms of a generalised reverse-charge, allow VAT receipts and the obligation to account for the tax collected to be concentrated in one of the links in the chain of economic transactions.

Germany estimates that it loses approximately 18 billion euros in VAT receipts[32] per year due to VAT fraud. The magnitude of these figures, approximately 11% of total VAT receipts, has forced Germany to seek solutions to reduce fraud. After a thorough study, Germany is convinced that there are no effective solutions to fight fraud within the current VAT framework.

The UK, Germany and Austria have all asked the Commission – pursuant to Article 395 of Directive 2006/112/EC (formerly article 27 of the 6th VAT Directive) – for a derogation allowing them to introduce the reverse-charge mechanism for essentially all transactions between taxable persons in their countries. The UK has sought to apply this to a specific sector of goods, particularly mobile phones, and microchips and related computer equipment. Both Germany and Austria have applied for a wholesale application of the reverse-charge to all transactions, above a certain limit. In the case of Germany this general reverse-charge would be combined with one of the two models of control: "R-Check" or "Cross-Check" – see below.

Under the reverse-charge mechanism, the person liable for the payment of the VAT on this transaction is the recipient/buyer. The supplier/service-provider would be solely responsible for indicating the transaction to the Revenue service.

This system of a generalised reverse-charge thus causes VAT to be applied only at the end of the chain, at the retail level. There is thus a break with the current VAT system, in particular regarding the fractionated payment of the tax at the level of each economic transaction.

[32] Letter to the European Commission, dated 19 December 2005, by MD Florian Scheuerle, Bundesministerium der Finanzen [Federal Finance Ministry] 11016 Berlin, Reference: IV A 2 – S 7050 – 208/05.

Fractionated payment is at the core of the VAT system. It is at the base of three essential characteristics of the system:

- **It allows advance payment of VAT receipts to the States** because the State does not need to wait for the completion of the economic chain of the good or service (sale to the consumer: the actual person liable for the payment of the VAT due) to receive the tax on consumption.
- **It allows self-policing of the tax** because each operator in the chain requires from his predecessor the documentation needed to prove the realisation of the economic transaction, the act having generated the tax.
- **It provides the State the security of collection of the receipts.** If one of the operators in the chain defaults, the State only loses a fraction of the tax: that corresponding to the value added by the defaulting taxable person. On the other hand, if the tax is concentrated in one link of the chain, his default causes the total loss of the tax on the good or service.

Advantages

- Increased receipts of the States. Germany estimates it would have additional revenues of 3.8 billion euros if this method were to be combined with the "R-check"[33] control method.
- According to Germany, a 25% reduction of VAT losses due to the insolvency of companies[34].
- Allows the immediate VAT recovery (no pre-financing) and avoids the VAT refund discrimination between zero-rated businesses and tax-collecting business, since there would be no refund requests required.
- Germany and Austria have enjoyed positive experiences via the use of reverse-charge in other areas – for example, construction industry.

Disadvantages

Arguments against the reverse-charge are contained within the Commission's ruling on Germany and Austria's request for derogation[35]. They include the following:

- **Burden on business** - under the reverse charge system, the financial risk arising from the non-payment of VAT is transferred from the Treasury to businesses. It is the latter that bears the risk when deciding whether or not to charge VAT based on validating the status of their customer as a genuine taxable person. Such shift of responsibility from the tax administration to business with potential costs for business runs counter to the "Lisbon" objectives.

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[33] Ibidem.

[34] Ibidem.

[35] Communication From The Commission To The Council in accordance with Article 27(3) of Directive 77/388/EEC, COM(2006)404 FINAL

- **Diffusion of VAT** - the rule of thumb in all Member states is that 80% of the VAT is paid by less than 10% of the taxable persons. This means that under the existing rules, very little control effort has to be invested by Member states' tax administrations to be guaranteed the bulk of their VAT revenue.
- **New forms of fraud** - it is to be expected that new forms and patterns of fraud would occur after the introduction of a more generalised reverse charge system. Passing the liability to account for the tax down the "chain" would make it more interesting for the last business in the supply chain to disappear. It should also be clearly noted that the reverse charge mechanism is not an answer to "black sales" (i.e. off the record sales) which remain outside the official circuit. For a taxable person, who has to charge VAT at the end of the supply chain, the incentive to obtain "black" supplies will increase as he has to account for the total amount of the VAT and no longer just for the fractionated part in relation to his "value added".
- **Increased burden for tax administrations** - tax administrations would have to significantly increase the number of control officials to deal with the greater risk arising from the tax debt being spread over a larger number of taxable persons.

Other disadvantages of the generalised "reverse-charge" include:

- Significant initial costs of setup and operation of the new systems.
- The limits suggested by all three countries - above which the reverse charge would be mandatory - cannot stop fraud; this would be committed by carrying out multiple transactions below the threshold or by other types of fraud such as "free of tax" supplies for instance.
- The loss of fractioned payments of the VAT under the current situation should mean the introduction of additional obligations to assure that the tax, which is normally paid in stages, is not put at risk.
- Each business would have to verify the status of its customer and/or the purpose of the purchase, since the reverse charge only applies if the customer is a business duly VAT registered acting as such.
- Each business would have to keep two invoicing systems (B2B and B2C) or organise a flexible invoicing system to be adapted for billing VAT-registered businesses or non-registered businesses or even private persons and, as the case may be, to deal with any subsequent changes to the status of the customer.

- Each business would have to provide periodically (monthly or quarterly) a list of his registered customers and file it with the tax authorities.
- The risk that some transactions are not declared at one point in the chain transaction, and consequently subsequent transactions, is not eliminated and all the parties in a chain transaction must continue to be controlled.
- The hijacking of VAT identification numbers would not be eliminated.
- The risk that "tax free" goods end up in other Member states.

Conclusion

According to the Commission, a "specific" and targeted reverse-charge system provides advantages to Member states provided that it is applied in certain economic sectors only, such as construction and goods with high value added. However, the difficulty of applying a limited reverse charge to certain products is that fraud would likely move onto other goods or services not covered by this system.

Perhaps one of the greatest risks of a general reverse-charge system to be implemented within a specific jurisdiction, is the possibility that the fraud would be exported to other Member states who did not have this provision in place. This creates unknown levels of risk which would need in our view to be considered very seriously.

In our view the generalised reverse-charge generates far too high a level of risk for the receipts of the Member states; especially since the concentration of the tax and its payment takes place with the retailer (defaulting retailer).

In 1962, the Neumark[36] report already commented that a "retail tax is not practicable as the sole form of turnover tax" for reasons of fiscal methodology:

- A large number of taxable persons have to be monitored, including small retailers most of whom are unable to keep precise accounting.
- Difficult handling of the preferential systems for small and medium-size businesses.
- Insecurity of receipts for the States due to bankruptcies of the retailers during payments of back-taxes.
- Increased possibilities for fraud, in particular purchases and sales without invoice since the goods are circulating between completely untaxed operators, causing a reduction not only in the level of VAT receipts but also of other taxes and social security contributions.

[36] Report of the Fiscal and Financial Committee, EEC Commission, 1962, p. 44.

In addition, this method transforms the VAT into a "Sales tax"[37]. A "Sales tax" type of retail tax is not a very efficient tax and is a source of considerable tax evasion. According to the IMF, this tax is only relevant for low tax rates of between 5 to 10%.

There are few official estimates of the actual levels of retail sales tax (Sales tax and Use tax) gaps in the US, however the IMF[38] mentioned in a recent report that it is about 1,3% for sales tax and 28% for Use Tax (retail tax on the out-of-state purchases, somewhat analogous to losses on intra-Community supplies within the EU) in Washington State.

In the recent French report of the *"Conseil des prélèvement obligatoires"*[39] it was mentioned from informal sources that tax evasion in a country such as the US applying a Sales tax system, is estimated at about the level of 30%.

Consequently, it seems that a Sales tax is likely to cause greater tax evasion than a tax such as VAT.

4. TAXING INTRA-EU TRANSACTIONS

One of the key weaknesses in the present transitional system, is the ability to purchase and sell goods and certain services intra-EU, tax-free. This creates one of the key characteristics of the menacing 'carousel' type frauds, where the opportunity to claim fraudulent VAT refunds arises principally because of the break in the VAT chain that occurs as a result of the zero-rating of intra-EC exports.

A paper published by the Institute for Fiscal Studies (IFS)[40] in the UK, concludes that a *"..systematic reform that eliminates the root cause of missing trader fraud would be a much more appealing long-term strategy than the combination of resource-intensive enforcement operations and ad hoc 'fixes' such as extended reverse charging, which may provide temporary relief but do not address the underlying problem."*

The IFS goes further to suggest that Member states should now reconsider the taxation of intra-EU supplies at point of origin, as this was too quickly dismissed in the run up to the removal of fiscal frontiers at the beginning of 1993.

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[37] The United States has a tax on sales to final consumers *(sales taxes and use tax)*. This is a tax on retail sales collected at a single stage. Unlike VAT, *sales taxes* have no possibility for deduction. Their systems are quite variable from one State to the other in terms of base rate, exemptions or rates (from 4% to 9%). This tax is not applied to all the States of the United States; some States have given the collection of this tax to the local jurisdictions. *Sales taxes* represent 33% of the states' fiscal receipts. (XIXth Report to the President of the Republic concerning the VAT, Conseil des Impôts, June 2001).

[38] *VAT Fraud and Evasion : What Do We Know, and What Can be Done?*, Keen M, Smith S, IMF Working Paper, February 2007, p. 22.

[39] *La fraude aux prélèvements obligatoires et son contrôle,* Report of the Conseil des Prélèvements Obligatoires, March 2007, p.286.

[40] The Green Budget 2007 – IFS, January 2007

The problem of rolling back the clock and re-imposing fiscal frontiers has already been discussed under "1. Country of Origin vs Country of Destination" above. For these reasons, we believe that a solution of taxation at the point of origin will not achieve political consensus.

Nevertheless, there is an innovative approach to tackling VAT fraud which has already been suggested by the Commission in their communication of a coordinated strategy to fight fraud[41]. *"In examining possible changes to the VAT system to fight tax fraud, the taxation of intra-Community transactions should be considered, either at a single rate, which should be high enough to rule out any incentive to set up a carousel fraud, or at the rate of the receiving Member state."*

The proposed solution here, therefore stops short of suggesting a move towards the origin system – but at the same time removes the financial incentive of carousel-type fraud, via the imposition of VAT on cross-border transactions, either at the rate of the receiving Member state, or at a single "EU" rate at a rate of 10%.

Advantages

- The end of zero-rated intra-community supplies and thus an end to the financial benefits of carousel fraud.
- A 'partial' return to the system of taxation at all stages of the production, distribution and service provision cycles, as recommended by the first VAT directive.
- A reduction in administrative burden and compliance for businesses who – presumably – will no longer need to file specific declarations of intra-community traffic as goods will now be taxed.

Disadvantages

- The re-imposition of fiscal frontiers, which would – initially – be viewed negatively by businesses.
- Costs associated with initial set-up.
- Cash flow implications for businesses who have to finance the VAT payments prior to being able to offset / reclaim the VAT.

Conclusion

The magnitude of the current levels of fraud, coupled with the urgency of Member states to react and put measures in place to address this, creates a necessity to consider all possible solutions – even those that are fundamentally different to the status quo. In determing various

[41] COM(2006)254 final.

fixes, we have already considered that a piecemeal modification to the transitional system is not likely to produce a long term, sustainable solution to the fraud problem.

The removal of the "zero-rating" of intra-EU supplies is one which appears to fulfil the basic requirements of simplicity, proportionality and legal certainty while maintaining the basis of a fractionated payment system. The IVA is of the view that this method, in combination with other conclusions reached below, will provide a credible way forward in the fight against MTIC-type fraud but unless additional controls are introduced to ensure that the VAT charged by the supplier is effectively paid over the risk is that other types of fraud might appear such as "deliberate insolvencies" or invalid deductions of input VAT.

5. FISCAL SUBSTITUTION

Fiscal substitution is a fiscal method that allows the tax to be concentrated at the beginning of the chain of taxable transactions. It is also possible to choose the economic operator who will be liable for the payment of all the VAT due in the chain.

It is desirable to have the choice of the operator liable for the payment of the VAT being the operator who is financially solid and adds the greatest value added within the economic chain. This is the case for example of auto manufacturing plants because the distributors and dealers have a rather narrow, predictable margin.

The method consists in choosing one of the economic operators in a chain as being the person legally liable for the payment of the VAT. This operator will request payment by his client of two amounts of VAT: The VAT "per se" for the operation and the VAT for "fiscal substitution".

The VAT per se is calculated based on the value of the operation between the person liable for the payment of the VAT and his client. Substitution VAT is calculated based on an "indicative value". The VAT thereby obtained is deducted from the operator's VAT per se. This difference will be paid by the client to the supplier and the supplier in turn pays the tax to the state. In the case of intra-Community sales the supplier (liable for payment of the VAT) pays the VAT directly to the state of destination.

In other words, in this transaction the client is asked for the price of the transaction plus the value of the substitution VAT. This client in turn will not be VAT taxable during his sales transaction, and likewise for all subsequent operators in the chain.

Further details of the Fiscal Substitution method are set out in Appendix 2.

Advantages

- Concentration of the tax in the strongest link of the chain or the one with the highest value added. Thus, compared with the reverse-charge mechanism, it is observed that fiscal substitution is less risky for the tax receipts of the States than the reverse-charge system.
- The end of carrousel fraud, because there is no longer any ephemeral operator.
- A closer relationship between the taxable person and the Revenue service.
- The Revenue service is more sensitive to the economic stakes of the sector.
- A smaller number of taxable persons.
- The persons liable for payment of the VAT are more solvent because the choice of this person also takes into account the solvency of the links of the chain.
- Despite the absence of the fractionated payment system, the benefits that that system provides are maintained. In fact, the State maintains the advance payment of the receipts and the security of collecting the receipts. Self-policing of the tax is maintained up to the link of the chain where the fiscal substitution is applied, whereas further down the chain it is no longer necessary.
- No impact on small and medium-size businesses, because they are more at the retail level.

Disadvantages

- Being a fundamental change to the existing VAT system, the implementation of this method would be difficult and costly.
- The cost of financing the cash flow of the VAT; this is normally reduced to a minimum by the indicative value of the sale adopted compared to the actual value of the transaction.
- Fraud of the type where purchases and sales are effected without invoice is not affected by this method.
- The substitute deducts his deductible input VAT from the amount of the VAT to be paid to the State. The substitute must request the refund of his deductible VAT (VAT on real-estate, office equipment, etc.[42]); there will thus be an increase in VAT refund requests.

Conclusion

Despite the apparent benefits of this solution, it would require a fundamental change to the existing VAT system and although it works in a federal type system within, for example Brazil, it would require significant adaptation to the EU's 27 Member states' existing legislation and practices in order to operate within the EU.

[42] This does not concern the VAT on the transaction for which he is the substitute, because this is not deductible.

6. VAT GROUPING

Article 11 of Directive 2006/112/EC, (formerly article 4.4 of the EU 6th VAT Directive 77/388/EEC), allows for Member states the possibility, after consultation with the VAT Committee (article 398, to introduce into their VAT legislation a VAT Grouping measure allowing for taxable persons closely linked by economic or financial ties to be treated as a single taxable person.

The article restricts the application of the provisions to businesses established in the same Member state.

The experience of Member states allowing domestic VAT groupings does not indicate any disadvantages such as loss of revenue or lack of flexibility, and more Member states (eg Spain and Belgium) are applying the measures in progress. In the recent PricewaterhouseCoopers report for the Commission on the taxation of Financial Services, it was noted that 86% of surveyed businesses are reluctant to outsource operations because of the potential VAT costs. If VAT grouping were made mandatory for Member states to introduce, this would reduce VAT flows between businesses and the inherent risks of fraud.

Concerning cross border VAT grouping, for which article 11, as currently drafted, does not provide, it can be observed that in a situation with no cross border VAT grouping, when comparing two businesses operating in various Member states supplying services, the one operating as a holding with subsidiaries would be at a disadvantage compared to the one operating as a single European company because the holding has to tax intra-group transactions, whereas a Single European Company, on the application of the ECJ decision in FCE Bank, does not have to account for transactions between different parts of the same legal entity.

This measure could either be voluntary or the tax authorities could impose grouping to protect VAT receipts. This would effectively prevent "carousel" type fraud between Member states and between related parties.

Lastly, it is noted that the various taxation systems have advantages and disadvantages and that independently of the system chosen, the fight against fraud also requires adopting more efficient inspection and control measures by the Revenue services.

Advantages

- As VAT groups create the concept of a 'single taxable person', supplies made between members of a VAT Group are disregarded for tax purposes. This could reduce the opportunity for cross-border carousel fraud between related businesses as VAT would not be charged on goods and services provided within a VAT group.

Disadvantages

- Aligning VAT Grouping legislation between all EU Member states would prove to be very difficult and costly.
- Fraudsters would use different vehicles to conduct fraud outside a Group structure.
- Anti avoidance provisions would have to be very tightly drawn and consistently applied in all EU Member states to prevent abuse.
- The fraud opportunities would be extended to services outside a Group, where it is much more difficult to control cross border movement, due to the intangible nature of services.
- The fraud would be pushed further down the VAT chain to the retail or consumer end.

Conclusion

Apart from the legal challenges associated with formulating the concept of a VAT group that crosses borders, the biggest obstacle to the effectiveness of this potential solution, is the practical difficulty in identifying members of a connected group. Fraudsters are already capitalising on masking their operations through buffers and brokers (see fig 1) which are difficult to track, and bringing connected parties together within the structure of a VAT group would prove, in our view, to be very difficult.

INSPECTION AND CONTROL MEASURES

The globalisation of markets poses a challenge for the Revenue services as regards the inspection and control of taxable transactions to prevent tax evasion and fraud.

It is the Member states' responsibility to manage the operation of the tax systems. However, the intra-community and international magnitude of fraud and tax evasion require a closer cooperation between the Member states of the European Union and also between the Member states and third countries.

New technologies can clearly play a major role for the Revenue services in the fight against fraud.

Among the inspection and control measures able to reduce fraud, there are the "Cross-check", the "R-check" and the cross-verification of electronic invoices (A). The corollary of these measures is the requirement to have a reinforced system of cooperation between the Revenue services in matters of administrative and collection assistance (B).

Only the use of new technologies will allow the Revenue services to achieve the goal of controlling VAT efficiently without increasing the costs of compliance for companies and in particular without making the VAT system even more complex.

In this sense, Germany has proposed two inspection mechanisms: "Cross-check" and "R Check". Brazil, Chile and Mexico, amongst others, use electronic invoicing as an inspection and control mechanism for taxable transactions.

1. CROSS-CHECK

The "cross-check" mechanism was proposed by Germany within a cash basis accounting model. Applying this model, the VAT becomes payable by the supplier at the time of payment of the transaction by the client.

However, the right of deduction of the VAT for the client will arise with payment of the tax to the State by the supplier. A default in the payment of the VAT by the supplier thus results in the client losing his right to deduct the VAT, despite the fact that the client paid the VAT in the price to the supplier.

The "cross-check" mechanism requires the filing of an individual return for the operation, in electronic format, when the payment is received by the supplier. Only individual operations for which the payment value and the invoice value are greater than €5,000[43] all taxes included, will be required to be declared on an individual return.

The electronic individual return with have to provide the following data:

- Seller's VAT number;
- Purchaser's VAT number;
- Invoice issuing date;
- Invoice number;

[43] Threshold established by Germany.

- Payment value received;
- VAT amount;
- Date of the payment;
- Type of payment: cash, cheque, credit card, etc.

At the end of each month, the seller and the purchaser must file the return with the total amount of the transactions carried out in the period.

The “cross-check” makes it possible to compare the information of the individual return with the data from the VAT turnover return. It also makes it possible to identify the transactions that have not yet been paid for by the suppliers’ customers.

Advantages

- The production of an alert signal in the event of default on payment allows the Revenue services greater ability to react in cases of ephemeral operators. However, this signal is not indicative of fraud because the taxable person may just simply be late with the individual notification or with the payment, etc.
- Allows a comparison of the VAT paid by the seller with that declared as received by the purchaser and also a comparison of the various turnover amounts declared.
- The method is compatible with the system of fractionated VAT payments as established by the First EU VAT Directive.
- This method is applicable either to a system of origin-based taxation, or a system of destination taxation.

Disadvantages

- Fraud may be carried out by issuing several invoices and payments below the threshold.
- The cross-check is not reliable to identify fraud; it is only a tool for identifying default. It is the Revenue service’s responsibility to verify the existence of fraud or failures in the system.
- Increased cost of compliance for companies, because they must file several individual returns per day depending on the number of clients. That will be even more tedious for small and medium-size businesses that currently enjoy simplifications (e.g. filing annual returns).
- Reduction of a company’s cash flow if payment of the VAT to the State must take place at the time of the individual return for transactions above the threshold. Small and medium-sized businesses will be more sensitive to this loss compared to the current method.

Conclusion

The cross-check system is versatile to the extent that it can be applied both within a system of origin or destination based taxation. While the simplicity of the arguments for cross-checking is compelling – particularly to the extent that is serves as a 'warning signal' to Administrations – the costs and disruption to businesses, including the effect on innocent traders who will have to wait until their suppliers pay the VAT before they themselves will be entitled to deduction, may in our view, outweigh the potential benefits.

2. R-CHECK

The control method by "R-check" was proposed by Germany to assure the flow of information to the Revenue service concerning domestic transactions between taxable persons, specifically linked to the proposed reverse-charge mechanism, for which Germany is seeking a derogation.

Application of the reverse-charge leads to the taxation of all economic transactions in the chain at one time, at retailer level. The reverse-charge is applicable only between taxable persons among whom the recipient has the right to deduct (prorated) 100% of the VAT.

The objective of the "R-check" is to allow the supplier to verify the "quality" of the client in real-time by a reliable computerised method by the verification of the validity of the "R-number" supplied by the client, as well as his name and address[44].

Combined with this verification, all transactions subjected to the reverse-charge system must be communicated to the Revenue service by the seller on a real-time basis, via the "R return". This return must contain the following data:

- Seller's VAT number,
- The "R-number" supplied by the client,
- Invoice number,
- Invoice date.

Advantages

- The "R-check" is indispensable in cases of application of the reverse-charge mechanism to check the exemption of the transaction against the quality of the client. It is not much different from the verification of the VAT number already existing for intra-community deliveries.

[44] Currently, for verification of a client's VAT number in order to exempt the intra-community transaction, the supplier does not have access to the address or name of the company.

- It reveals in real-time whether or not the "R-number" provided by the client is a valid number.

Disadvantages

- The method is very limited because it only prevents one type of fraud, the providing of a false VAT number or "R-number". However, it does not prevent the use of a real "R-number" for purchases for final consumption.
- Increased compliance costs for companies, in particular small and medium-size businesses, due to the individual returns for the transactions.
- An initial cost of 2 billion euros[45].
- Cost of operation for the Revenue service: 5 billion euros[46].
- Cost of operation for German companies: 200 million euros per year[47].

Conclusion

The R-check system will require a fundamental change in the existing VAT system with costs to businesses and governments likely to be very substantial. The system will neither deal with undisclosed transactions, nor the potential hi-jacking of numbers.

3. CROSS-VERIFICATION OF ELECTRONIC INVOICES

The method of cross-verification of invoices has been used since 1970 in Korea and China[48]. However, the development of data processing has given a new impetus to this type of fiscal control to fight against fraud.

The countries of Latin America, in particular Brazil, Chile and Mexico benefit to a certain extent from the advantages provided by new technologies which has enabled them to develop a method of cross-verification of electronic invoices with the objective of reducing fraud. In the case of Brazil[49], cross-verification of electronic invoices is in keeping with the broader objective of simplifying and reducing companies' administrative costs, in particular concerning returns for turnover, registrations in various States, etc.

A majority of large and medium-sized businesses already use computer resources for their bookkeeping. The issuing of electronic invoices is thus desirable because it is in keeping with this context of simplification by the use of data processing.

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[45] IVA Conference Dublin May 2006.

[46] Ibidem.

[47] Ibidem.

[48] *VAT Refunds: A Review of Country Experience,* Harrison G, Krelove R, IMF Working Paper, November 2005.

[49] This is in the process of being implemented with the cooperation of the largest Brazilian companies.

The system operates as follows:

When issuing digitally certified electronic invoices[50] to the recipient, companies send a copy of the invoice to the Revenue service of the client's State and another copy to the Revenue service of the supplier's State. This electronic invoice receives an "approval" from the Revenue service of the supplier in real-time, allowing the recipient to deduct the VAT and the supplier to carry out the delivery without needing to pay the VAT at that moment[51].

The Revenue service of the supplier's State verifies the supplier's status, his integrity vis-à-vis payment of the VAT and also the existence of the deductible VAT able to be compensated with the VAT of the transaction in question, all in real-time basis.

Once this method is applied to all transactions, the Revenue services' information system is able to know, for each company, the invoices it has received according to its purchases and the invoices it has issued at the time of its sales. The company thus no longer needs to provide turnover returns and returns for exchanges of goods for statistical purposes, for example.

The electronic invoice uses a harmonised model that includes all required information: the descriptions of the goods, the quantities, the necessary data or controlled goods that may cause environmental damage[52], etc.

Advantages

- ❖ Simplification of companies' compliances obligations and consequently a greater reduction in costs.
- ❖ Improving the Revenue services' ability to react in identifying potential fraud. The measures to protect public revenue are taken in real-time: advance payment for the transaction, communication to the client that the VAT will not be deductible, establishing the responsibility of the recipient, etc.
- ❖ The agreement and participation of the companies to implement this method. In fact, there is a dual benefit for companies: reduction of the administrative cost of the tax and reduction of unfair competition in the sector due to fraud.
- ❖ An environmental measure in order to reduce the use of paper.
- ❖ Increased confidence in digitalisation and development of the use of new technologies.
- ❖ Gains in legal security for the client company, because it knows before paying its supplier that the deductible VAT of the transaction will not be called into question by the Revenue service due to fraud by the supplier.

[50] The model of the electronic invoice is harmonized in all Brazilian states.

[51] The company will pay the VAT at the end of the period. This can be a two-week or one-month period.

[52] A copy of these invoices concerning the goods controlled is available for the Ministry responsible for control thereof, all by computer means.

Disadvantages

- The method does not prevent all types of fraud. Fraud in selling and purchasing without invoices (black market) still escapes this method.
- The initial set-up costs associated with implementing a cross-checking solution are substantial and would require wholesale changes to the methods of conducting business in the EU.
- The initial implementation time required to successfully implement an effective cross-verification system would be protracted and difficult to achieve in the short term.
- The success of this solution requires a highly effective and integrated information system across all Member states, with Revenue administrations who are able to share and react to the information efficiently.
- The effective use of cross-verification as a tool against VAT fraud would be best served if implemented across the broadest base of economic operators. It is unrealistic to assume that all businesses would have the necessary systems and technology in place (at least in the short to medium term) to interact, and therefore it is envisaged that many businesses would simply fall outside of the net.

Conclusion

The use of electronic cross-verification will only come into play when both supplier and customer have the necessary systems and technology in place. Invariably, this holds true for the larger and, arguably more stable economic operators, who most likely sit on the right side of the compliance spectrum and are less prone to be involved in mischief. While the advantages of cross-verification provide an interesting solution, it can only achieve a meaningful tool in the fight against fraud if its application is mandatory and widespread across all Member states.

Given the costs associated with implementing such a system on such a broad basis, it unlikely that this option will gain traction as a plausible alternative to the status quo.

4. INCREASED USE OF NEW TECHNOLOGIES

There are a number of ways in which the use of technology can be deployed as a tool to reduce the risks of VAT fraud, and improve the overall efficiency of the European VAT system. Certain initiatives already have the commitment of Member states – such as the improvement of the VAT Information Exchange System (VIES), which is a work in progress – and alternative solutions are in the process of being formulated.

In line with the conclusions reached under 'Cooperation Between Revenue Services' below, it would be most beneficial if Member states approached how best to develop and implement innovative technologies, in a structured and coordinated manner. This would ensure that the benefits are spread across all jurisdictions, thereby deterring fraudsters from attempting to exploit weaknesses inherent in some.

Advantages

The effective use of technology can lead to:

- Reduction in administrative costs for both the taxpayer and National Revenue Services.
- Faster response times to the threat of fraud and ability to prevent fraud rather than responding to it.

Disadvantages

- One potential disadvantage involves the implementation of technology that would not be readily accessible for wide-spread use by taxpayers. This would create an environment of dual processes which creates a additional burden on business as well as National Revenue Services.
- Depending on the type of technology deployed, the initial set up costs may be high both for businesses and National Revenue Services.

Conclusion

It would be important also to examine the further benefits of technology to limit the scope and extent of fraud in the area of VAT. In particular the use of XBRL (Extensible Business Reporting Language) to tag and identify transactions so as to report them in a consistent format, facilitating the analysis and detection of fraud, may be a way forward – which should be considered further.

Real-time reporting - and giving tax authorities open access to businesses' accounts to validate and verify transactions as they were recorded - provides tax authorities with a much improved position in preventing fraud. Similarly, it must also facilitate a more speedy validation of VAT reclaims in order to refund them without any delay. The existing "transitional" VAT system would not be incompatible with such uses of new technologies.

5. TRADITIONAL CONTROL MEASURES

Apart from innovation into new areas of control, as discussed above, there remain the traditional forms of control that could be deployed in a more effective basis in order to control the rising levels of fraud. These would include the following:

- Tighter checks on firms seeking to register for VAT - accompanied with appropriate levels of guarantees.
- Tighter checks on VAT refunds.
- Random checks on intra-Community supplies of goods transported to identify undeclared transactions (mobile audit and control teams).

In addition to this - and, whilst it may be a retrograde step as far as it runs against the "Lisbon" principles - a number of suggestions have been made to reintroduce VAT representatives, as existed prior to Directive 2000/65 EC[53]. The motivation behind these suggestions are to provide a greater degree of certainty and security for the National tax administrations. This proposal has not been investigated further in this report.

Advantages

- Rogue traders can be prevented from entering the VAT system via blocking the initiation of a VAT registration. In the case of missing trader fraud, this cuts off the oxygen supply on which the fraud relies.
- These traditional tools can be deployed with relative speed and with relatively quick results.

Disadvantages

- Many innocent traders may be affected, which places extreme financial burdens on their businesses.
- These measures are ideally suited to addressing specific risks as they appear today. No sooner has one avenue been blocked, the fraudsters take to other avenues in pursuit of their mischief.

Conclusion

Whilst it is true that subjecting VAT registrations, repayment claims and intra-EU traffic to additional checks provides Revenue Administrations with an effective tool to fight certain types of VAT fraud (especially missing trader type frauds), it is vitally important that these

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[53] Council Directive 2000/65/EC of 17 October 2000 amending Directive 77/388/EEC as regards the determination of the person liable for payment of value added tax.

measures are not applied in a disproportionate and discriminatory manner, which affects the rights of legitimate taxpayers.

On the other side, these controls become diluted at the macro-economic level, when measures are concentrated only in a handful Member states. This 'transports' the risk of fraud to other Member states, thereby diluting overall effectiveness.

There is a balance to be struck in the application of traditional forms of control, which should be a combination of proportionate measures, coordinated and implemented on a broad scale across all Member states.

COOPERATION BETWEEN REVENUE SERVICES

These days, fraud is no longer an internal problem specific to any one individual State. Fraudsters' operations use the failures or the absence of systems of cooperation between the States to achieve their objective.

Therefore, before increasing the tax compliance burdens for taxable persons, the Revenue services should consider all tools at their disposal, including the improvement of administrative cooperation between Member states and third countries.

ADMINISTRATIVE COOPERATION: INTRA-EU

In 1993, the EU introduced a common system of administrative cooperation and exchange of information between the competent authorities of the Member states to ensure proper application of VAT and to combat fraud.

The legal basis for administrative cooperation in matters of information sharing is Regulation (EC) 1789/2003, and in matters of assistance with collection, Directive 2001/44/EC.

The key rules as defined within the regulation governing mutual assistance are as follows:

- Provide clear and binding rules on facilitating information exchange and VAT investigations.
- Entrust direct cooperation between tax officials from different Member states, while retaining the pivotal function of the central control offices.
- Prescribe when Member states should (at least) exchange spontaneous information.
- Prescribe the exchange of information specific to intra-EU traffic, via VIES (VAT Information Exchange System).

In addition to this, the Commission published a comprehensive Risk Management Guide in 2006, produced by tax officials from the various Revenue Administrations, as an output of the Fiscalis Risk Analysis Project Group[54]. This guide was developed to provide a common foundation for decisions at all management levels within tax administrations.

The legal framework in place, governing matters of information sharing, are judged satisfactory by the Commission. However, it deems that "the Member states do not make sufficient use of the new possibilities thus provided and the level of the use of the administrative cooperation arrangements is not in keeping with the magnitude of intra-Community trade"[55].

As regards VAT, given that rapid access to information is crucial in combating fraud, more efficient methods of exchanging information, taking account of recent technological developments and the equipment used by traders, should be envisaged. More frequent and more detailed automated exchanges between Member states, or even direct access to national databases, should to be considered for this purpose. The required modernisation of the VIES system presents an opportunity for implementing some of these improvements.[56]

Member states, in turn cite the problem of language, the lack of human resources and the lack of familiarity with the cooperation procedures at the level of their own tax audit staff. In fact, the personnel assigned to administrative assistance, contribute to the tax receipts of all the other States except those of the State that remunerates them. That explains the lack of personnel, because the indirect benefit resulting from reciprocity is hard to measure.

In addition, the financial soundness of companies that bear the payments of back-taxes of various Member states will be reduced. It is the duty of the Member state where they are established to suffer the indirect consequences such as the reduction of personnel or investment, etc.

Lastly, the Member state where the company is established can benefit indirectly from the fact that the company does not pay its taxes to other Member states, because a priori these funds remain in the State and are applied in the local economy.

It is possible that the above examples go some way in explaining the inertia within the respective Revenue Administrations towards administrative cooperation. However, this should not serve as justification. There are three distinct solutions to this problem:

1. Establishing a supervision system to ensure that each State actually does provide effective assistance to its counterparts;

[54] Risk Management Guide for Tax Administration, February 2006

[55] COM(2006)254 final.

[56] COM(2006)254 final.

2. Establishing financial incentives by the States and/or the inspectors having a stake in a "bonus" from the income collected (receipts actually collected) from the work carried out within the framework of international cooperation;
3. Creating a multi-jurisdictional "community revenue service unit", comprised of officers from each Member state with an expanded competence to fight fraud, in particular the right to make visits and to seize property.

In fact, the "community administrative culture" is the result of a greater integration amongst the Revenue services. That can be obtained through multilateral audits and also with Community financial incentives.

It is clear that a financial bonus in the salaries of officers participating in multilateral audits or administrative assistance would have the result of reducing language barriers to a minimum and increasing the efficiency and utilisation of the available resources. This bonus could be paid, for example from a fund coming from the payments of back-taxes arising from the application of the mutual assistance arrangements.

The legal framework within which this increased level of cooperation would operate – which might be modelled on the OLAF arrangements – will need to be agreed between the Member states.

ADMINISTRATIVE COOPERATION: 3RD COUNTRIES

The phenomenon of globalisation of the economy finds its corollary in the globalisation of fraud.

According to the Commission *"the increased involvement of companies established in third countries in carrousel fraud, electronic commerce and the globalisation of the services market highlights the need for international cooperation in matters of VAT"*[57].

International cooperation in matters of direct taxes results from the bilateral treaties: the International Tax Treaties. The current version of the OECD model, approved by the OECD Committee on Fiscal Affairs on June 1, 2004, expands the application of Article 26 (administrative assistance clause) to cover indirect taxes, including VAT.

Since the amendment is recent, it is not yet effective in being able to provide for the necessary administrative assistance as it has to be "transposed" into each one of the bi-lateral tax treaties. The discussion of these conventions tends to be quite lengthy and the third countries cannot accept the expansion of this clause to cover taxes other than direct taxes automatically.

[57] COM(2006)254 final.

Nevertheless, the ratification of bi-lateral treaties with third countries including a clause on VAT assistance is crucial.

CONCLUSION

The existing EU invoice-based VAT system has proven its efficacy in collecting substantial sums of tax revenue for the Member states over the past 40 years. It is due to its success in the European theatre, that value added tax, with a fractionated payment mechanism at its core, has been exported and replicated to over 130 countries worldwide as the preferred basis for an efficient and sustainable tax on consumption.

However, recently, the high and increasing levels of VAT fraud in the EU, and its movement into areas such as services, is beginning to affect Member states' international trade statistics and current account balances, the consequences of which require action on a determined and coordinated basis. Notwithstanding all the merits of the existing system, it is clear that something must be done in order to reverse the current trend.

SUMMARY OF SUBSTANTIVE ISSUES

In this paper, we have provided an analysis of a number of potential solutions that could be adopted in order to respond to the risks of fraud.

- The report started with an assessment of the **country of origin vs the current transitional system** (which taxes most intra-Community traffic at the point of destination). Whilst we fundamentally agree with the Commission's views that taxation at the point of origin is the most effective modus operandi of the Single Market, we recognize the political obstacles to reaching consensus on the harmonisation of VAT rates and the collection and redistribution of taxes necessary to support an origin-based environment.

- The report then focused on **whether modifying the existing transitional system** would achieve the desired results. Here, we concluded that one of the key contributors to the complexity of the existing rules - and corresponding costs of compliance – is largely attributable to piecemeal modifications of the existing transitional system over the years, coupled with various, **ad hoc 'fixes' which go someway to providing temporary relief, but do not address the long term problems.**

- The next step was to focus on the **application of a general reverse-charge mechanism** on domestic transactions and whether this would provide a real long-term solution to

addressing VAT fraud. While we acknowledge the limited and short-term relief that this would bring, we concluded that the risks associated with a fundamental shift away from a fractionated payment system, to taxation at the retail level, would broaden the potential scope of fraud and lead to losses exceeding those experienced today.

- The report then considered the possibility of **removing the zero-rating of intra-EU taxation**, which facilitates the strategies associated with carousel fraud. Here the report supports the Commission's view, that taxing intra-EU traffic using either the rate of the receiving Member state, or a flat "EU" rate of about 10% would significantly reduce the incentives for MTIC fraud, but without additional controls being put into place could lead to an increase in "deliberate insolvencies" or input tax fraud.

- The report then reviews the methods **of fiscal substitution and VAT groupings**, however, in the final analysis, we do not believe that anyone of these solutions would effectively stop the increasing levels of fraud and would require substantial changes to existing VAT systems.

- In the report's penultimate section, five different types of **inspection and control measures** are reviewed, including Germany's 'Cross-check' and 'R-check' proposals, invoice-verification methods used successfully in South American jurisdictions and other traditional types of controls to assess the veracity of a taxpayer's operations. One of the key findings arising from this review relates to the traditional controls and the potential for improvement on an EU-wide basis if methodologies were coordinated and implemented in a consistent manner across all jurisdictions. New technology is playing a major role in the control of VAT fraud but there is clearly significant scope to increase its use.

- The final section of the report focuses on the solutions offered by enhanced **administrative cooperation**, concluding that there is ample scope for significant traction in the fight against fraud, utilising the legislative framework already in place and bolstered by the introduction of a multi-jurisdictional unit that is appropriately motivated to achieve results.

CONCLUDING REMARKS

Having reviewed the different solutions available, we believe that the existing, "transitional" VAT system, with some significant changes, is capable of avoiding and reducing the existing perceived levels of fraud.

In fact, the existing VAT system has proven to be a very safe and efficient way to collect a broad based consumption tax. Its intrinsic qualities allow Revenue services to collect tax at high rates:

it is a "money machine[58]". This explains why of course, since 1954, it has been adopted by more than 136 countries all over the world.

As a consequence we believe that any changes to the existing system to fight against tax fraud, must not call into question the fundamental principles of VAT: it is a matter of preserving the rules of a game that are equitable for legitimate businesses but at the same time ensure the continued improvement in the efficiency of the Revenue services.

Moreover, in our view, the actions to be taken must be undertaken and coordinated at EU level and not be done on a "piece meal" basis at Member state level giving rise to conflicting interpretations, legal uncertainly and increased cost for business.

So where does the "ideal" solution reside? The use of technology must be extended to allow businesses free access to global markets, but should be used on the other hand, as a valuable control tool by the Revenue services. Further and more widespread use of existing techniques, of risk analysis, validation of VAT registrations and of requiring payments onto blocked accounts should be examined, but on a coordinated and consistent basis across all Member states.

However, none of the solutions being put forward in this paper will eradicate VAT fraud entirely but a number of the conclusions drawn – in our opinion – will contribute significantly towards reversing the current trend.

The IVA looks forward to contributing further to Europe's debate on this important subject.

[58] *VAT Fraud and Evasion : What Do We Know, and What Can be Done?*, Keen M, Smith S, IMF Working Paper, February 2007, p.3.

APPENDICES

APPENDIX 1: TIMELINE OF EU VAT DEVELOPMENTS

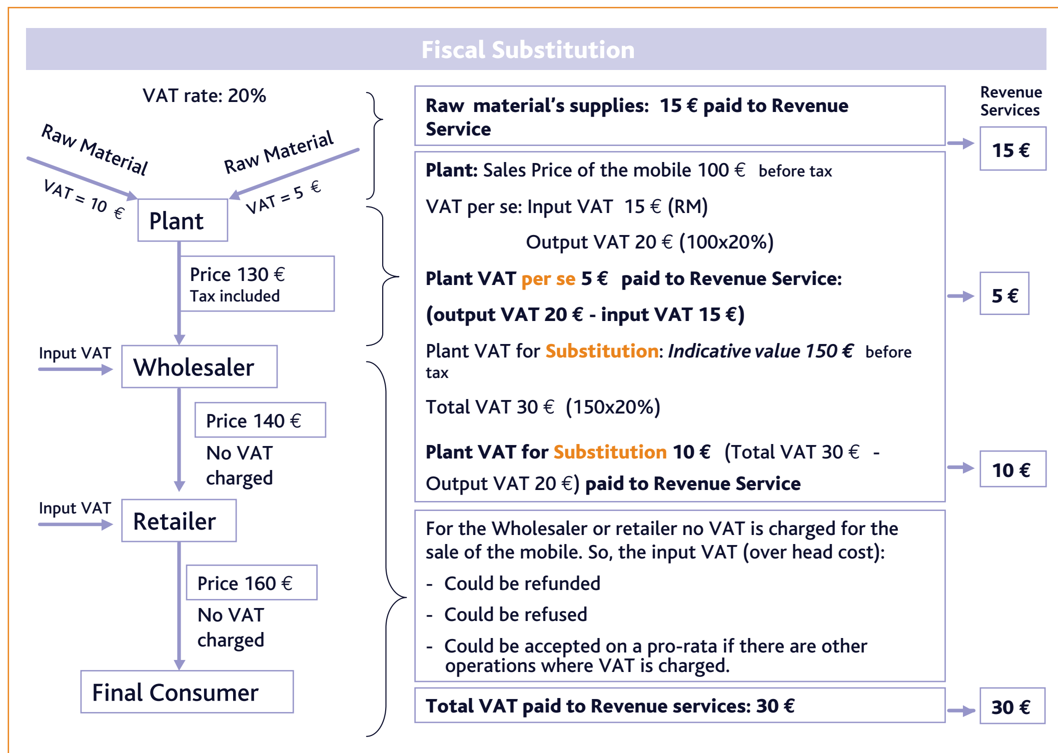
Year	Development
1951	The original 6: Belgium, The Netherlands, Luxembourg, Germany, Italy and France sign a treaty forming the European Coal and Steel Community.
1957	Treaty of Rome ("EC Treaty") is signed. It forms the European Economic Community (EEC). It becomes effective on 01.01.1958. The EC Treaty is the basis for co-operation between Member states on direct and indirect tax matters with the aim to removing any trade barriers and therefore to promoting and enhancing the internal market.
1967	Adoption of the first 2 VAT Directives, establishing a general, multi-stage but non-cumulative turnover tax to replace all other turnover taxes in the Member states. These Directives laid down only the general structures of the system and left it to the Member states to determine coverage of VAT and the rate structure.
1973	UK, Ireland, Denmark join the EEC.
1976	Directive 76/308/EEC of 15 March 1976 ensures mutual assistance and administrative co-operation between all EU Member states.
1977	Adoption of the Sixth VAT Directive. Establishes a uniform VAT coverage in all Member states. This guarantees that the VAT contributed by each Member state to the Community budget can be calculated. It still allows Member states to have many possible exceptions and derogations, resulting in largely un-harmonised VAT systems in the EEC.
1981	Greece joins the EEC.
1983	Spain and Portugal join the EEC.
1985	Single European Act sets out the timelines to abolish internal borders within the EEC.
1987	The Commission tables a proposal aimed at introducing a VAT system aimed to work like within a single market.

1993	Realization of the EU Single market by the abolition of controls at fiscal frontiers. To achieve this, the Commission proposed to move from the pre-1993 "destination principle" to an "origin based system". This was not acceptable to Member states as the rates of VAT were too different, and there was no adequate mechanism to redistribute VAT receipts to mirror actual consumption. Therefore, a transitional VAT system was adopted maintaining different fiscal systems but without frontier controls.
1995	Austria, Finland and Sweden join the EEC
2001	Directive 2001/112/EC on VAT invoicing amending the 6th VAT Directive. To be implemented into national law by 01 .01.2004.
2002	Directive 2000/65/EC of 17.10.2000 eliminates the requirement for a fiscal representative for Inter Community traders
2004	Cyprus, Malta, Czech Republic, Estonia, Hungary, Poland, Latvia, Lithuania, Slovakia, Slovenia join the EU
2007	Romania and Bulgaria join the EU
2007	Directive 2006/112/EC repeals the EU Sixth VAT Directive 77/388/EEC, as well as the First and Second Directives, in a major exercise which has simplified the text of the principal VAT legislation in Europe.

APPENDIX 2: FISCAL SUBSTITUTION AS A MEANS OF COMBATING VAT FRAUD

Fiscal substitution is a method that allows the tax to be concentrated at the beginning of the chain of taxable economic transactions. It is also possible to choose the economic operator who will be liable for the payment of all the VAT due in the chain.

It is desirable to have the choice of the operator liable for the payment of the VAT, being the operator who is financially solid and provides the greatest value added to the economic chain. This is the case, for example of auto manufacturing plants because the distributors and dealers have a rather narrow, predictable margin.The method consists in choosing one of the economic operators in a chain as being the person legally liable for the payment of the VAT. This operator will request payment by his client of two amounts of VAT: the **VAT per se** for the operation and the **VAT for fiscal substitution.**



The **VAT per se** is calculated based on the value of the operation between the person liable for the payment of the VAT and his client. **Substitution VAT** is calculated based on an "indicative value". The VAT thereby obtained is deducted from the operator's VAT per se. This difference will be paid by the client to the supplier and the supplier in turn pays the tax to the State. In the case of intra-Community sales the supplier (liable for payment of the VAT) pays the VAT directly to the state of destination. In other words, in this transaction the client is asked for the price of the transaction plus the value of the substitution VAT. This client in turn will not be VAT taxable during his sales transaction, and likewise for all subsequent operators in the chain:

Take the example of a mobile phone manufacturer and the subsequent stages of the production through the distribution chain;

For example, the plant sells to the wholesaler a mobile for €100 before VAT. The VAT rate on this transaction is 20% and the "indicative value" of the sale to the final consumer is €150 before tax.

- **VAT per se** of the operation is €20 (100 x 20%)
- Deductible VAT is €15 (Raw materials)
- Net **VAT per se paid to Revenue Service is 5 €** (20 €- 15 €)
- **VAT for fiscal substitution is €10** ((150 x 20%) – 20)[59]

[59] ((Taxable base x rate) – deductible VAT).

The invoice will contain:	the total value of the operation = €100 HT
	the VAT per se = €20
	the value by fiscal substitution = €10
	--
	Total to be paid by wholesales = €130

So, **the plant** receives from the wholesaler €130 and pays to the Revenue service €15 (5 +10) being the total VAT on the mobile (plant to final consumer).

The wholesaler has paid €130 for the mobile and sells the mobile to the retailer for €140. This operation is not subject to output VAT, nor is any input VAT allowed.

The retailer has paid €140 for the mobile and sells the mobile to the final consumer for €180 (effectively the tax inclusive price). This operation is not subject to output VAT, nor is any input VAT allowed.

So, for the transactions that take place after the plant (point of substitution) no VAT is charged, even if the price of the sale to the final consumer is higher or lower than €150 (indicative value). In fact, the Revenue service is able to accept the taxation on a value different than that of the actual operation due to the security of getting the VAT receipts in and also the effective advance payment of the funds.

The "indicative value" of the sale to the consumer is a mean market value obtained with the participation and the agreement of the economic sector concerned. These amounts are revised annually, or according to major changes in the economic sector, or at the request of the sector's representatives, or at the request of the Revenue service. The "indicative value" used, is - in principle - very close to the actual sales price paid by the final consumer.

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