

# VAT FRAUD: PROBLEMS AND A DUTCH SOLUTION

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## 1 Introduction

It has been said before, the amount of tax losses due to VAT fraud are staggering<sup>2</sup>. During the past years losses by national exchequers have seemed to explode as criminal organizations discovered VAT fraud was an easy way to make money. However, EU governments have now geared up their efforts in the battle against VAT fraud. In particular, the so-called 'Carousel' or 'Missing Trader' fraud is under severe attack. Various Member States have introduced special legislation targeting this form of fraud and sometimes even legitimate traders are caught in the line of fire. This is especially the case in the Netherlands where a far reaching VAT liability was introduced for anyone dealing in designated high risk goods.

## 2 A Description of VAT Fraud

VAT fraud almost always involves a mala fide entrepreneur somewhere in the chain, who invoices and collects VAT, but fails to pay it to the tax authorities. That failure to pay is not detected until later, by which time the VAT has already been embezzled. The tax authorities can find only a bogus company (called '*ploffer*' in Dutch). Sometimes a 'paper' fraud is involved, and there are no actual goods in existence. In most cases the fraud is committed while trading in goods which do exist.

Carousel fraud is a special form of VAT fraud. Take as an example three parties who repeatedly trade in the same goods. Two of the parties are in the

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<sup>2</sup> See, for instance, Kenneth Walker, The Future of Value Added Tax in the European Union, ECTJ 6/1, [2002] 1.

Netherlands and one is in the UK. Party 1 (UK) sells goods at the zero-rate to party 2 (the Netherlands). Party 2 (the Netherlands) sells to party 3 (the Netherlands), applying the local 19% VAT rate. Party 3 (the Netherlands) sells to party 1 (UK) at the zero-rate and the cycle starts all over again. In this carousel, party 2 (in the Netherlands) pockets VAT at every turn.

Naturally, there are endless variations on this theme. A carousel is established once the goods start going around in circles in one direction or another. Even if complex flows of transactions are established, the fraud essentially remains remarkably simple - a bogus trader collects VAT but fails to pay it to the tax authorities. Whether a carousel is established makes no difference with respect to the seriousness of the fraud.

Perhaps 'Missing Trader Fraud', a term used by UK Customs, really captures the essence of this kind of illegal activity. According to UK Customs<sup>3</sup> fraudsters obtain VAT registration to acquire goods VAT-free from other Member States. They then sell the goods at VAT inclusive prices and disappear without paying over the VAT paid by their customers to the tax authorities. It is not the carousel of goods which constitutes the problem, but the disappearance of traders and VAT.

### **3 Estimates of Loss and Actions Taken**

The total amount of VAT evaded can only be estimated. According to the Commission no reliable and comparable methods of measuring the level of fraud are available. Detected VAT fraud in intra-Community trade, however, accounts for a considerable loss in receipts<sup>4</sup>. During the first half of 1998 Member States detected 250 cases of such fraud, involving a revenue loss of around €500 million. Looking at recent figures from some national authorities, UK Customs calculates a yearly loss of approximately €2.2 billion<sup>5</sup>. German tax authorities mention yearly losses ranging up to €10 billion<sup>6</sup>. Belgian authorities estimate a minimum yearly loss of €1.1 billion<sup>7</sup>. Dutch authorities mention losses of

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3 HM Customs and Excise, Tackling Indirect Tax Fraud, November 2001, this document can be accessed from the Treasury's Internet Site: <http://www.hm-treasury.gov.uk>

4 Mr Bolkestein on behalf of the Commission answering written Question E-1890/01, Official Journal of the EC C 160 E/4 (4th July 2002).

5 HM Customs and Excise, Protecting Indirect Tax Revenues, November 2002.

6 As estimated by the German Federal Audit Office.

7 Press release from the Belgian Federal Police, 8th November 2001.

several hundreds of millions. Although only estimates, these amounts certainly call for appropriate action.

By now most EU countries have taken specific measures against carousel fraud. In the UK, for instance, VAT pre-registration procedures were tightened further to detect and prevent more fraud before it commenced<sup>8</sup>. The efforts to recover missing trader debts from detected fraudsters were increased. Also criminal proceedings were geared up. During 2001-02 prosecutions were brought against eleven individuals for missing trader fraud, resulting in jail sentences totalling almost fifty years. Customs further claims to be working closely with legitimate traders in the retail sectors most affected by this form of fraud. In practice, existing carousel frauds are stopped by refusing to grant VAT refunds until a verification of the entire transaction chain has been carried out. Such postponement of VAT refunds certainly also affects legitimate traders. Quite a way to be working together!

In Germany specific liability<sup>9</sup> has been introduced for anyone claiming a refund of VAT on purchases. If this purchaser knew or should have known that the supplier would not pay the VAT to the tax authorities, the purchaser can be held liable for this unpaid VAT. The liability also extends to prior transactions. For instance in an A-B-C transaction if customer C knows that trader A does not account for its VAT, customer C can be held liable for VAT not paid by A, although C did not trade directly with A (but purchased its goods from B).

On a European level there has been a clear commitment to strengthen control and administrative co-operation. At the end of 2002 the Fiscalis 2007 program was approved by the Council and European Parliament. This program will help Member States work more closely together with a view to preventing tax fraud, through improved electronic exchange systems between national administrations, co-operations in investigations, training seminars for tax officials and experts and the exchanges of officials between national administrations. Fiscalis 2003-2007 replaced and strengthened the existing Fiscalis program which expired at the end of 2002. The European Anti Fraud Office ('OLAF') is also providing coordination and assistance activities to Member States confronted with carousel fraud<sup>10</sup>.

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8 HM Customs and Excise, Protecting Indirect Tax Revenues, November 2002.

9 This measure is known as: *Steuerverkürzungsbekämpfungsgesetz* of 19th December 2001.

10 Report of the European Anti Fraud Office for the year ending June 2002, <http://www.europe.eu.int/olaf>

#### **4 Countering Fraud the Dutch Way**

In the Netherlands counteracting fraud connected with VAT payments, whether or not in carousel form, was not given priority until the second half of the 1990s. Controlling fraud proved to be very difficult. The problem was that the tax authorities were legally powerless in a number of cases where the fraud was discovered afterwards. If a supplier lacked financial resources or had gone bankrupt, been wound-up or had disappeared, the unpaid VAT could no longer be collected. On the other hand, requests for VAT refunds relating to purchases from such missing traders had to be honoured. Previously, the tax authorities could bring an action based on a wrongful act against trading partners in the event of a manifest conspiracy. The wrongful nature lay in the fact that the entrepreneurs benefited from the VAT fraud knowingly and willingly. In practice, it was difficult to prove that a benefit had been consciously derived.

Called to action by fellow Member States, the Netherlands in 2002 introduced a far-reaching liability<sup>11</sup> on entrepreneurs involved in a trade chain in which VAT fraud has been committed. Under the new legislation, any entrepreneur trading in designated 'high risk goods' can be held liable for VAT that has not been paid elsewhere in the trade chain.

The list of high risk goods includes computers, cars, telephones and audio equipment and parts or components thereof. The condition is that the entrepreneur knew or should have known of the fraud. Such incriminating knowledge is readily assumed. The incriminating knowledge is at any rate assumed where a benefit has been derived. A benefit will be deemed to exist if prices are kept artificially low. The liability does not apply only to the direct supplier or customer of the bogus company, but extends to all previous and subsequent traders, all of whom may be held liable by the tax authorities. Thus, all parties in the trade chain can be called to account.

#### **5 High Risk Goods**

The current list of appointed high risk goods includes the following (all including parts and components):

- (a) Telecommunications and computer equipment and computer software;

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<sup>11</sup> Apparently based on the German approach.

- (b) Photographic, film, video and audio equipment as well as image and sound carriers, such as video and music cassettes and compact discs and digital video discs;
- (c) Land vehicles equipped with engines with a cylinder capacity or power of more than 7.2 kW.

New goods can be added to this list by ministerial decree.

## **6 Liability and Exculpation**

Liability extends to all VAT that was not paid or that will not be paid on the sale of the same goods. If there are a number of missing traders in the trade chain, the liability amounts to the total sum of VAT that those bogus companies failed to pay when the goods were supplied. In a long trade chain with many traders missing, the liability can reach substantial amounts.

The liability thus extends to all entrepreneurs in the trade chain. That includes not only a bogus company's customer and the subsequent traders, but also the supplier of that bogus company and any previous suppliers. The circle of parties that can be held liable is basically unlimited. The term of liability is also unlimited. There is a restriction in that the goods must be on the list of high risk goods, both at the time when the entrepreneur to be held liable traded them and at the time of delivery when VAT was not paid or not fully paid. Finally, there is no territorial limitation to the liability. Any trader anywhere in the world can be held liable.

Liability can arise only if the trader knew or should have known that VAT was not paid or will not be paid somewhere in the trade chain. In particular the 'should have known' concept is broad and imposes a duty of investigation on the entrepreneur. Entrepreneurs will also be confronted with the tax authorities' hindsight. Once the fraud has been discovered, signs can often be found, based on which the entrepreneur 'should have become suspicious'. The relevant issue is the care that a reasonable, socially responsible entrepreneur may be expected to exercise in commercial contracts. Due care may be expected in the event of unknown suppliers, unusual quantities of goods or unusually low prices. In addition, unusual conditions of delivery may play a role in the 'should have known' presumption. What it ultimately means is that anything unusual is suspicious, which is not a very clear guideline in practice.

The entrepreneur is deemed to have been aware of the fraud if he has derived a benefit from the fraud. Such a benefit is in any event presumed if the selling price

is lower than the actual market value. A benefit is also assumed if the selling price is lower than the price paid for those goods earlier. The legislative proposal thus introduces a fictitious benefit in the event of an unusual price, and thus a suspicion of complicity or an assumption of sharing in the benefit.

Regular buyers and sellers will be hindered by this fiction. For example, certain goods are subject to strong price fluctuations. In such a case, how can the amount be established that 'would have been paid in the event of free competition'? Any such determination is speculative. It creates an uncertainty that cannot be excluded for the buyer. It is even more difficult to determine the 'remuneration that was charged to the supplier or to each supplier with respect to earlier purchases'. A normal entrepreneur cannot possibly have that information and will always run a risk.

Bona fide entrepreneurs need not be afraid of the proposed legislation, according to the Dutch tax authorities. 'Bona fide' in this context means trading with fixed partners, selecting suppliers with due care and applying customary market prices. An entrepreneur who is held liable can object. If the entrepreneur is held liable because he was found to have received a benefit, he can dispute that liability successfully only if he can provide reasonable evidence that the benefit does not originate from or does not relate to the failure to pay VAT or to pay it in full. In fact, the entrepreneur must provide reasonable evidence that he would have paid the same price if there had been no fraud. In the writer's view, that evidence is almost impossible to provide.

## **7 Suspension of Payments, Bankruptcy and Debt Rescheduling**

There can be no liability in relation to a failure to pay VAT on supplies if the supplier has suspended its payments, been declared bankrupt or is covered by a debt rescheduling scheme for natural persons. The relevant supply may have been made by the party under suspension of payments, bankruptcy or a debt rescheduling scheme and/or by their administrator/trustee. In addition, supplies may be involved that arise from a pledge created on the goods. Dutch law considers those situations to be bona fide, and no liability will arise, even if the customer knew that VAT would not be paid or not be paid in full.

## **8 Comments**

VAT fraud, including carousel fraud, occurs on a scale that is completely unacceptable. Each year, billions of euros in government funds disappear to

unknown destinations. The fraud also distorts competitive relations. From that perspective, any form of crackdown is welcome.

Combating carousel fraud should be a matter of working together. Cooperation not only between Member States, but also between tax authorities and legitimate entrepreneurs. Liability of the Dutch kind ignores the cause of the problem. The perpetrators themselves are not being tackled. Instead, the tax authorities recover the unpaid VAT from other traders. Whether this party was actually aware of the fraud seems to be of secondary concern. With threatening liability and legal presumptions that are difficult to refute, the trade in high risk goods has indeed become risky. Whether bona fide businesses will ultimately reap the benefits of this approach still remains to be seen.